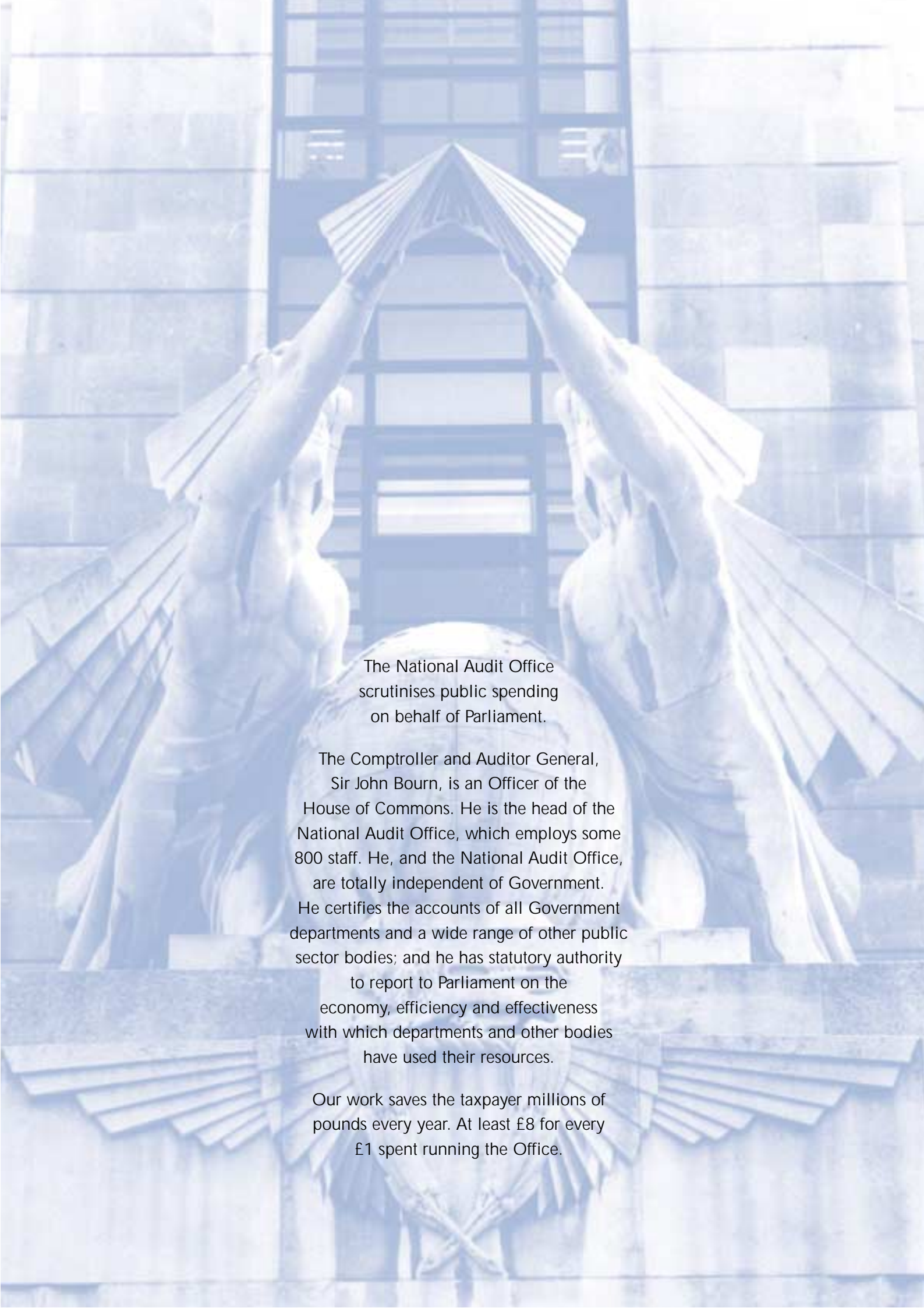


HM Customs and Excise
Tackling VAT Fraud

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 357 Session 2003-2004: 3 March 2004





The National Audit Office
scrutinises public spending
on behalf of Parliament.

The Comptroller and Auditor General,
Sir John Bourn, is an Officer of the
House of Commons. He is the head of the
National Audit Office, which employs some
800 staff. He, and the National Audit Office,
are totally independent of Government.
He certifies the accounts of all Government
departments and a wide range of other public
sector bodies; and he has statutory authority
to report to Parliament on the
economy, efficiency and effectiveness
with which departments and other bodies
have used their resources.

Our work saves the taxpayer millions of
pounds every year. At least £8 for every
£1 spent running the Office.

HM Customs and Excise
Tackling VAT Fraud



REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 357 Session 2003-2004: 3 March 2004

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

John Bourn National Audit Office
Comptroller and Auditor General 19 February 2004

The National Audit Office study team consisted of:

Peter Lilly, Richard Gauld, Lee Summerfield,
Adrian Farley, Helen Hawkins, Ian Mackenzie and
Sarah Rollinson under the direction of Jane Wheeler.

This report can be found on the National Audit Office web site at www.nao.org.uk

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

© National Audit Office

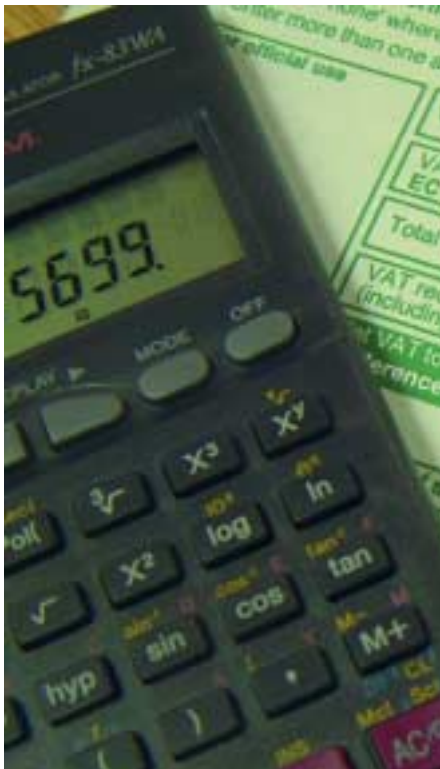
Contents

Executive summary	1	Part 3	
Recommendations	6	Tackling VAT Missing Trader Intra-Community Fraud	25
Part 1		How fraudsters take advantage of EU arrangements to steal VAT	25
The risks to VAT revenue	9	Customs' action to tackle VAT missing trader fraud	27
The amount of VAT collected by Customs	9	Preventing missing trader fraud	28
Customs' estimates of the amount lost on VAT	9	Detecting missing trader fraud	28
Customs' approach to tackling VAT losses	10	Part 4	
How Customs are organised	11	Tackling the shadow economy	31
Part 2		The scale of losses from non-registration	31
Detecting, investigating and preventing fraud	13	Detecting traders operating in the shadow economy	31
Customs' assurance work on the VAT collected by traders	13	Appendices	
Customs' intelligence work on the risks to VAT	14	1. Study Methodology	35
Customs' investigation and prosecution of VAT fraud	15	2. The organisational structure of Customs	38
Preventing fraud	24	3. Recommendations made by Lord Grabiner	39
		4. Glossary of Terms	41

executive summary



- 1 Value Added Tax (VAT) is a self assessed tax on the supply of goods and services, introduced in the UK in 1973. It is collected by 1.7 million registered traders and paid over to Customs. In 2002-03 Customs collected net VAT receipts of £63.6 billion, made up of just over £108.8 billion in receipts of which £45.2 billion was repaid to businesses that had paid more VAT on purchases than they had collected on sales and could reclaim the difference. Traders may not pay the correct amount of VAT for a number of reasons including error, deliberately understating their VAT liabilities or through systematic attacks on the VAT system. Customs estimate that the amount lost on VAT could be around £11.9 billion in 2002-03, which includes substantial non-fraud losses. The Government has set Customs a target to stop the long-term growth in the size of the overall VAT gap and to cut it from 15.7 per cent in 2002-03 to 12 per cent of the total amount that could be theoretically collected from VAT by 2005-06. This report examines Customs' approach to:
 - detecting, investigating and preventing VAT fraud (Part 2);
 - tackling the most serious type of VAT fraud known as VAT missing trader intra-Community fraud where bogus traders register for VAT, buy goods VAT free from another EU Member State, sell them on at VAT inclusive prices and then disappear without paying over to Customs the VAT they have collected (Part 3);
 - those traders operating in the shadow economy who fail to register to pay VAT (Part 4).
- 2 On VAT missing trader fraud, Customs estimate that losses amounted to £1.65 billion to £2.64 billion in 2002-03 which was a reduction on the previous year. They became concerned about this type of fraud in late 1999 and in September 2000 introduced measures to tackle it. Customs published details of additional steps being taken to tackle this fraud in November 2002 and April 2003. On the shadow economy, Customs estimated the losses to be £400 million to £500 million in 2001-02 (the latest figures available).
- 3 To evaluate Customs' methodology for measuring fraud and error, we employed specialist economic and risk management consultants. We interviewed staff at locations around the UK and analysed operational data to establish how Customs prevent, detect and investigate fraud. We spoke to a number of organisations and individuals in the public and private sector and overseas to identify examples of good practice in tackling fraud. Our work helped us to assess whether Customs' approach matched best practices and identify where improvements could be made. Our methodology is set out in Appendix 1.



Estimating the VAT losses

- 4 Customs have done well to estimate the scale of losses on VAT and are leaders in Europe in this type of work. They have determined how they need to respond to the problem, the resources needed and set targets for reducing the loss. Customs' estimates are necessarily subject to a margin of error because of the number of assumptions made and the reliability of the data used. Research by our consultants established that Customs have used appropriate methods to estimate the VAT losses and have made the best use of the data available, even though these are subject to uncertainty. Customs have estimated the trends in losses for VAT missing trader fraud and are carrying out further work on estimating other losses to determine whether their response is proportionate to the risks.

Preventing Fraud

- 5 Customs are giving increased emphasis to helping traders comply with their VAT obligations by improving guidance and support and offering solutions to businesses which have problems. For example Customs have produced a range of guidance for new businesses on their responsibilities including some in cooperation with other government departments and trade bodies. Such information can be important to businesses operating in the shadow economy which may not fully understand the requirements to register with Customs where their turnover exceeds £56,000 a year.
- 6 Fraud comes in many guises from traders from omitting the occasional sale from their records to systematic suppression of sales or falsification of purchase invoices. Other fraudsters may have little or no legitimate business activity and register with Customs for the purpose of stealing VAT. An example of this is missing trader intra-Community fraud where fraudsters pose as genuine traders to purchase goods VAT free in other Member States, sell on at a paper loss and then disappear without paying to Customs the VAT collected on sales. Customs are seeking to prevent potential missing trader fraudsters from registering with them. In 2002-03 Customs' checks on new registration applications led to 914 suspect applications being refused or around 0.35 per cent of those applying to register. They also attached conditions to many other registrations (such as requiring the trader to provide financial security) because of concerns about possible fraud.
- 7 In the European Commission's view, a fundamentally different system to the way in which VAT is administered in respect of Intra-Community transactions would help amongst other things to tackle missing trader fraud. The alternative system would involve traders paying VAT in the Member States where the goods are produced, known as taxation in the place of origin. The Commission considers that the scope for the current type of missing trader intra-Community fraud would be reduced as goods would no longer be traded VAT free between States. However, taxation at the point of consumption (the current system) is a widely accepted principle within the EU and it is unlikely that political agreement would be reached on any changes, especially as it is generally accepted that the alternative system may require closer harmonisation of VAT rates with implications for products and services which the UK currently zero rates. Although the incidence of this type of missing trader fraud might be reduced such a change would result in an increase in other types of fraud such as repayment frauds using false invoices. The alternative system is not viewed as a practical option at the present time and it is not the responsibility of Customs to take forward. Customs and some other Member States have therefore developed their own approach to tackling missing trader fraud. Customs have also worked with the European Commission and some other Member States to develop good practice guidelines for tackling it.

Detecting non-compliance and fraud

- 8 To tackle non-compliance in the general trader population Customs audit the systems of the largest traders and select other traders for audit based on risk criteria. Their experience shows that around a third of traders under-declare their VAT liability for a variety of reasons and in 2002-03 their checks identified an additional liability of over £3 billion from their targeted visits. Customs have found that distinguishing between what is error and what is fraud is often not possible because of the difficulties in proving the intention of the traders. The thrust of their approach therefore is to deliver year on year improvements in the compliance of businesses with their obligations and maximising the yield.
- 9 Customs' Intelligence staff have an important role in establishing patterns of non-compliance and targeting activity at the high risk sectors of the economy. Since September 2002 Customs have been improving their approach to intelligence work by focusing on national, regional and local risks rather than individual leads. They also expect the introduction of e-Business applications across their operations by 2005 to help generate summarised real time information which will help them assess the risks to VAT revenue more accurately and quickly. In deciding on the resources to be allocated, Customs regularly review the risks to ensure these are focused on the priority areas set out in their strategies. In 2002-03 Customs allocated 13 per cent of their Intelligence resources on VAT work down from 16 per cent in the previous year. This was mainly because some Intelligence staff were redeployed onto higher yielding revenue work and improvements were made in the way staff are used on VAT work.
- 10 Some businesses operating in the shadow economy take deliberate steps to avoid registration by suppressing their declared turnover or fragment their businesses into separate units to show a turnover below the VAT registration threshold of £56,000 a year for each business. Some may also not realise that they need to register. Customs estimate they may be losing £400 million to £500 million a year from between 125,000 and 180,000 traders operating in the shadow economy who have not registered for VAT at around £3,000 to £4,000 in VAT for each trader. By working closely with the Inland Revenue and Department for Work and Pensions, Customs have detected almost 4,000 traders a year who should be registered, or around 3 per cent of the total estimated to be operating in the shadow economy. They get a good return on this work of around £16 for every £1 spent and are allocating more resources to detecting traders that should be registered. The work however is resource intensive because of the high turnover of businesses operating in the shadow economy.
- 11 In Budget 2003 the Government announced a one-off incentive scheme which ran from 10 April to 30 September 2003 for businesses which should have previously registered for VAT, but had not. These businesses would not incur penalties for late registration if they came forward voluntarily, assisted in establishing the amount of VAT due and paid any arrears in full and furnished all VAT returns and payments on time for 12 months after registration. By the end of December 2003, almost 3,900 applications for late registration had been processed under the scheme involving arrears in the region of £26 million. To help identify those who continue to operate in the shadow economy, Customs are taking forward an exercise to match selected Inland Revenue data with their own database of traders.



- 12** Customs make good use of information from a number of different sources to help them detect VAT missing trader fraud. One source of information is the notifications of suspicious transactions by financial institutions made to the National Criminal Intelligence Service which, over the last few years, have worked on increasing the numbers of notifications made. Another is a European Union information system which can detect possible intra-Community VAT frauds known as the VAT Information Exchange System or VIES (a computerised system for automatically exchanging information about VAT registered taxpayers and the value of their intra-Community supplies of goods). On the VIES, data on transactions can be at least three months old, and some traders do not record transactions or they record them incorrectly. With the support of Customs, the European Commission have been working on proposals to improve and strengthen administrative cooperation between tax authorities to tackle this type of fraud which are expected to come into force in 2004. Customs have also developed bilateral agreements directly with eight Member States and three other agreements are being pursued which will allow information to be exchanged more rapidly and which will help to identify fraudsters.
- 13** Where Customs detect a missing trader they will deregister the company to stop it trading, raise assessments for the amount of VAT owed, where possible obtain freezing orders on the company's bank accounts, and prosecute those involved where appropriate. During 2002-03 Customs also disallowed £63 million of VAT repayments to exporters suspected of being part of a supply chain where VAT had gone missing from carousel fraud (a type of missing trader fraud). In Budget 2003 further measures were announced to help Customs deal with companies who might be part of a missing trader supply chain, such as making a business jointly and severally liable for VAT unpaid on sales of mobile phones and computer components.

Investigations and Sanctions

- 14** Customs seek first to stop VAT frauds at the earliest opportunity to prevent any further losses, and second to impose a civil evasion penalty or prosecute those involved. Decisions on actions to be taken depend on whether the case falls within Customs' criteria on prosecutions (such as whether the business was set up with the intention to carry out fraud, the occurrence of other criminal activities, or whether lawyers, accountants and others who advise on VAT matters are involved), the available evidence, and the likelihood of evidence being obtained from another source or through investigation. Customs also seek to collect arrears to ensure that the economics of the crime are attacked and that penalties act as a deterrent.
- 15** Where VAT fraud is suspected, Customs look wherever possible to impose a civil evasion penalty which can be up to 100 per cent of the amount evaded. Customs generally only investigate with a view to criminal prosecution, the more serious or aggravated cases. For example, where the fraud involves the registration of one or more businesses whose activities are solely or primarily bogus, or the carrying out of systematic fraud against the VAT system. In September 2000, Customs introduced a strategy to tackle VAT missing trader fraud and, as part of this, reallocated investigation resources from less serious VAT cases to those involving missing trader fraud. Customs also began to target other more complex and larger value cases using their civil evasion procedures.
- 16** The number of finalised cases where civil evasion penalties have been imposed has fallen from 898 in 1997-98 to 276 cases in 2002-03 but the average value of each case has risen. In these cases Customs identified VAT evaded of around £27 million or around £30,000 a case in 1997-98 and in 2002-03 £16 million and around £59,000 a case. In April 2002 Customs introduced a new approach to tackling some VAT fraud cases which seeks to reach agreement with traders on the nature, extent and reason for irregularities. The indications are that the elapsed time to complete cases under the new civil evasion procedures is quicker at an average of nearly seven months compared with 11 months for those completed under the standard civil evasion procedures. Payment of arrears has also been more prompt and Customs case handling capacity has increased.

- 17 The number of VAT prosecutions finalised in courts has remained broadly constant in recent years at around 90 a year. Customs now concentrate on bringing to trial the more serious cases, such as missing trader frauds, where the amount of VAT lost can be considerable. Customs are currently working on around 100 ongoing missing trader fraud criminal cases involving VAT totalling some £2 billion, with over 80 of these cases awaiting trial. Of the 86 VAT fraud cases finalised in court in 2002-03, 69 resulted in convictions of which seven were for missing trader fraud. VAT fraud cases successfully prosecuted took on average two years and eight months to complete (including investigation and prosecution), with some taking over five years. The complexity of the cases has been an important factor in the time taken involving issues such as the number of defendants involved and the need to carry out the investigations in other jurisdictions, particularly for VAT missing trader fraud. The availability of court time can also delay a case. Early pleas of guilty could help to reduce the time taken on a case, especially where there are lengthy waiting times before the trial but there is little incentive in terms of reduced sentence to encourage such pleas before the trial and some defendants will wait until the early stages of the trial to enter a guilty plea.
- 18 The Butterfield report, published in July 2003, found that the basic training given to investigators is reasonably thorough but that subsequent training is somewhat ad hoc and not systematic and recommended that improvements should be made. Customs are continually developing the training of their investigators such as on the handling of informants and the disclosure of unused material on a case and supplement their training with instructions and guidance on investigative procedures and the law. Customs are now in the process of introducing national standards that will form the basis for future training in common with other Law Enforcement Agencies and in partnership with the Police Skills and Standards Organisation. The Butterfield report also recommended that Customs' Prosecutions Office should become independent. It concluded that, although over the last few years there had been considerable changes to the independence of the prosecuting lawyers in Customs, these changes had not gone far enough. Customs' lawyers needed to be in a position to exercise their "minister of justice " role without fear or favour and needed to be seen by others as in a position to do so. The Government has announced that an independent Customs and Excise Prosecutions Office will be set up during 2004 which will be directly accountable to the Attorney General.
- 19 Where Customs have prosecuted fraudsters they seek to recover the proceeds or benefit of the criminal activity through the use of confiscation orders. These orders can be a powerful deterrent to fraudsters as they tackle the economics of the crime. The enforcement of a confiscation order involves complex legal processes which, up to the end of December 2002, were managed exclusively by Customs' Asset Forfeiture Unit. At that time the Unit were handling around 330 confiscation orders with a value of £59 million. From December 2002 cases have been passed to a Task Force set up by the Home Office which enforces confiscation orders (whether obtained by Customs or by the Crown Prosecution Service). It can take many years to recover the assets. For example the courts may give the convicted person up to 5 years to pay, or there may be refusals to pay and Customs will monitor the case to see whether there are assets which can be realised to satisfy the confiscation order.
- 20 From February 2003, the newly created Assets Recovery Agency has been taking on cases from Customs and other agencies for civil recovery of assets where a criminal investigation has been carried out but it has proved impossible to continue with the criminal case and consequently there is no possibility of obtaining a confiscation order (which is dependent on conviction). The new civil recovery scheme enables the Director of the Assets Recovery Agency to take proceedings in the High Court for the recovery of the proceeds of unlawful conduct without the need for anybody to have been convicted of an offence. The Agency also has the option to tax the proceeds of crime where there are reasonable grounds to suspect that a person's income, profit or gain was obtained from crime.

Recommendations

On estimating VAT losses

- 21** Customs have made major strides forward in estimating the amount lost from VAT and over time this will allow them to assess trends. They have also produced estimates for specific types of loss that make up the total including the amount lost from VAT missing trader fraud and from failure by traders to register for VAT. Their estimates of losses from general non-compliance by registered traders is the largest area of losses ranging from £2.5 billion to £4 billion in 2001-02. Customs have not broken down these losses between those which are due to fraud and those which are due to error because of the subjective judgements that would need to be made on the intention of traders and the disproportionate resource Customs consider this would involve. If they could make the distinction between fraud and error then Customs would be able to assess whether the balance of their effort and the type of measures taken are appropriate. Against this background Customs should develop methods for estimating the amounts of fraud and error in the registered trader population.

On detecting fraud

- 22** Customs cooperate closely with other EU Member States to tackle VAT missing trader fraud. One mechanism which facilitates this is a computerised system for automatically exchanging information about VAT registered traders and the value of their intra-Community supplies of goods (known as the VAT Information Exchange System, or VIES). The value of VIES in tackling missing trader fraud can be limited as the data on the transactions will always be at least three months old, and some traders do not record transactions on the system or they record them incorrectly. Customs should continue to work with the European Commission to improve the quality of information used to detect irregularities by addressing the current weaknesses in VIES and related systems.

On investigations and sanctions

- 23** The number of cases where civil evasion penalties is imposed has fallen significantly although the average value of each case rose reflecting the targeting of more serious cases. The reduction in cases reflects the reallocation of staff to more serious criminal investigations where Customs will either prosecute a case, disrupt the fraud or dismantle the organised crime groups involved depending on the circumstances. Deciding on the balance between the different measures available requires difficult judgements on which combination is likely to have the best effect in deterring fraud. As part of their evaluation process, Customs should therefore assess whether they have the right balance of measures in place to reduce the VAT gap in line with the targets set by the Government.

- 24 In some cases, due to circumstances outside of their control, Customs may have to wait for up to a year for court time and lawyers to become available to try a complex case. Customs should assess with the Department for Constitutional Affairs whether there are opportunities to reduce the long wait for court time to become available in some VAT cases.
- 25 The new powers in the Proceeds of Crime Act 2002 which will allow Customs to seize cash should lead to criminal groups taking greater care in taking cash out of the banking system in the UK. Criminal groups may also intermingle legitimate and criminal funds through established businesses to confuse the audit trail and may place more assets overseas. Customs should identify how fraudsters are concealing their assets in these ways and how such devices can be countered by drawing on other countries' experiences. They should also work closely with the Assets Recovery Agency to uncover and realise hidden assets.
- 26 In response to the recommendations in the Butterfield report Customs are looking to improve the training provided to investigators. As part of this work Customs should raise the professionalism and standing of investigators by providing training to accredited professional standards.

On disseminating lessons learned

- 27 To encourage traders operating in the shadow economy to voluntarily register for VAT Customs introduced a one-off incentive scheme where they will not impose a penalty if the trader paid arrears of VAT in full and furnished returns on time for 12 months. There have been concerns that schemes of this type could be unfair to honest traders. To help other Departments assess the value of similar schemes, Customs should disseminate the lessons learned from the one-off incentive scheme.



Value Added Tax Return For the period to



Fold Here

Before you fill in this form please read the notes on the back and the VAT leaflet. Write in ink, and write 'none' where necessary. Don't put a dash or leave any box blank. If there are no figures to enter, write 'none'. Do not enter more than one amount in any box.



For official use	
VAT due in this period on sales and other outputs	1
VAT due in this period on acquisitions from other EC Member States	2
Total VAT due (the sum of boxes 1 and 2)	3
VAT reclaimed in this period on purchases and other inputs (including acquisitions from the EC)	4
VAT to be paid to Customs or reclaimed by you (the difference between boxes 3 and 4)	5
VAT due on all other outputs excluding your box 8 figure	6
VAT due on all other inputs excluding your box 9 figure	7
VAT due on related services, EC Member States	8
VAT due on related services, EC Member States	9

the schemes in the relevant letter(s) in this box. On behalf, must sign below.
BLOCK LETTERS
complete.
Date
declare that the
declaration can result in prosecution.

Part 1

The risks to VAT revenue

- 1.1 This part of the report looks at Customs' estimates of the amount of revenue lost on VAT, their targets to reduce losses and how they are organised to tackle losses.

The amount of VAT collected by Customs

- 1.2 VAT is a self assessed tax on the supply of goods and services, introduced in the UK in 1973, which is collected by approximately 1.7 million registered traders. Traders are required to register for VAT if their turnover of 'taxable' goods and services exceeds £56,000 in the previous 12 months or is expected to exceed this amount within 30 days.
- 1.3 In 2002-03, net VAT receipts totalled £63.6 billion, or just over 58 per cent of the total tax revenue collected by Customs (**Figure 1**). The gross VAT revenue was £108.8 billion, but Customs repaid £45.2 billion of this because businesses that pay more VAT on purchases than they collect on taxable sales can reclaim the net amount.
- 1.4 One of Customs' objectives is to collect the right amount of VAT at the right time. To do this, the Department seek to:
- make it as easy as possible for legitimate companies to pay their VAT;
 - make it as difficult as possible for criminals and dishonest companies to commit VAT fraud;
 - challenge what they consider to be abusive VAT avoidance schemes;
 - detect unregistered trading; and
 - identify traders who do not pay the correct amount of VAT which is referred to as general non-compliance.

The main types of fraud on VAT are

Missing trader intra-Community frauds - where fraudsters register for VAT, buy goods VAT free from another EU Member State, sell them on at VAT inclusive prices and then disappear without paying the VAT due to Customs.

Shadow economy fraud - genuine businesses with a turnover above the VAT registration threshold that deliberately do not register for VAT.

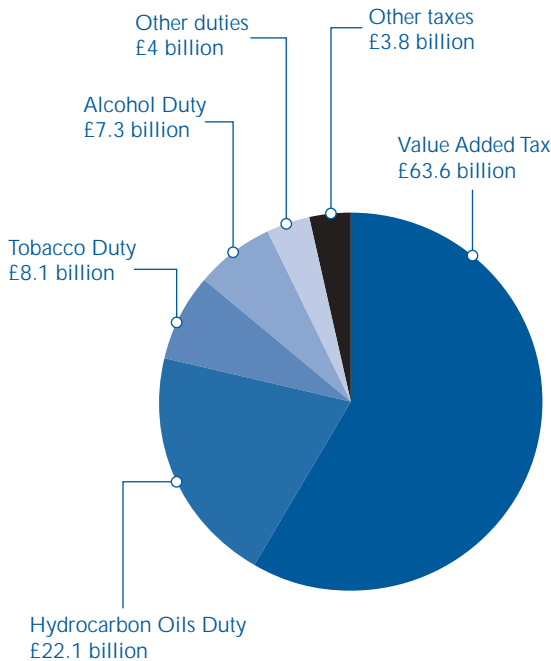
Repayment frauds - where fraudsters register for VAT, make false claims for repayments and then abscond.

Suppression fraud - where genuine businesses with legitimate trading activity perpetrate a fraud by understating a portion of their sales or by falsely inflating their claims for the VAT on purchases to reduce their tax liability.

Customs' estimates of the amount lost on VAT

- 1.5 Customs estimate that around £11.9 billion in VAT was lost in 2002-03 as a result of error, avoidance and fraud. This is equivalent to 15.7 per cent of the amount that could be theoretically collected in the absence of any losses, up from an estimated 14.7 per cent in 2001-02 and 9.9 per cent in 1990-1991. These top down estimates of VAT losses are based on a number of soundly-based statistical and economic assumptions although there is uncertainty in much of the underlying data. Customs have found it difficult to interpret the trend in the VAT gap and are looking into the reasons. Although it is too early to complete the VAT gap calculation for 2003-04, Customs believe that the gap may be closing because VAT receipts have been well above expectations.

1 Shows net revenue collected by HM Customs & Excise in 2002-03 in indirect taxes and duties



NOTES

'Other taxes' include Insurance Premium Tax, Landfill Tax, the Climate Change Levy and the Aggregates Levy. 'Other duties' include Air Passenger Duties, Betting and Gaming Duties, Customs Duties and Agricultural Duties.

Source: HM Customs and Excise

- 1.6 For 2001-02, Customs produced individual "bottom-up" estimates for specific types of loss such as missing trader fraud to provide a check on the plausibility of the top down figure of £10.6 billion in that year. The "bottom up" estimates were £7 billion to £10 billion (Figure 2). Customs are looking at how these figures can be updated.
- 1.7 Customs have done well to estimate the revenue losses on VAT and are leaders in Europe in this type of work. Our economic consultants who examined the methodologies used by Customs (Appendix 1) concluded that Customs had used appropriate methods to estimate the VAT losses and had made the best use of the data available, even though these are subject to uncertainty and statistical error.
- 1.8 To assess VAT losses from non-compliance, Customs have carried out checks since 2001 on a statistically representative sample of traders. As part of this sampling exercise, Customs' staff can not always assess whether underpayments found are due to fraud or error due to recklessness, carelessness or ignorance because of the judgements that would need to be made in some cases and the disproportionate resource Customs consider this would involve. Customs are unable therefore to split their estimate of non-compliance VAT losses between

fraud and error. However, as with all Customs VAT assurance activity, where evidence or indications of fraud are found, these are referred for follow-up action. In other cases their approach is to disrupt or deter non-compliance, to encourage compliance and assess what operational response is the most appropriate.

1.9 Factors other than the revenue losses also make it important for Customs to tackle fraud:

- The competitive position of businesses paying the right amount of VAT can be undermined by others who evade their tax liabilities.
- Where systematic criminal VAT fraud is involved the proceeds support the activities of organised criminal networks which may also be involved in other serious criminal activity such as drug smuggling.

Customs' approach to tackling VAT losses

- 1.10 Customs have adopted the approach used in their tobacco smuggling strategy as a model for tackling revenue losses in other areas including VAT. This has entailed moving from a tactical approach, where success was defined in outputs such as the value of assessments raised for unpaid VAT, to a strategic approach based on the achievement of outcomes, such as reducing overall losses from VAT missing trader fraud. Customs' new VAT strategy is set out in Protecting Indirect Tax Revenues, published in November 2002. It is based on an integrated approach which is intended to improve the service that Customs offers to businesses, make it simpler and less costly for these businesses to comply with the requirements of the VAT system and crack down hard on those who continue to abuse the system.
- 1.11 Total elimination of losses is not realistic because of the costs involved and the need for Customs to strike a balance between applying effective controls to protect the revenue, and ensuring that honest traders are not overburdened with compliance costs. The Government has therefore set Customs a target to stop the long-term growth in the size of the overall VAT gap and cut it to 12 per cent by the end of 2005-06. Customs estimate that reducing the VAT gap to 12 per cent would yield additional revenue of £2 billion a year by 2005-06. They plan to do this through more effective collection of VAT, better compliance with VAT regulations by traders, limiting opportunities for traders to use abusive avoidance schemes (the more complex schemes designed to save traders VAT and where losses to the revenue could be high) and by reducing fraud. The strategy is supported by the progressive deployment of more than 1,000 additional staff over the three year period 2002-03 to 2005-06 to the main problem areas to reduce the losses.

2 Shows the approaches used by Customs to estimate VAT revenue losses

Top Down approach

The **top down approach** entails comparing the total level of expenditure in the economy that is theoretically liable for VAT (the theoretical tax liability) with actual VAT receipts and assuming that the difference (the VAT gap) represents the total revenue loss. It is a global measure based mainly on data from the Office for National Statistics. Customs' estimates using this method show the total VAT loss as being £10.6 billion in 2001-02 and £11.9 billion in 2002-03.

Bottom up approach	Area of loss	Customs' estimate of loss in 2001-02 (£billion)
<p>The bottom up approach relies on operational and intelligence data as well as other sources of information to produce estimates of revenue losses from specific areas. Customs have used this approach to estimate losses from general non-compliance by traders, the failure of businesses to register when operating above the VAT threshold, VAT missing trader fraud and avoidance. Customs estimate that VAT losses from these totalled between £7.1 billion and £10.25 billion in 2001-02.</p>	Non-compliance by traders in paying the right amount of VAT at the right time either because of genuine mistakes or where they deliberately understate a portion of their sales or falsely inflate the value of purchases to reduce their VAT liability.	2.5 to 4
	VAT missing trader fraud where fraudsters register for VAT, buy goods VAT free from another EU Member State, sell them on at VAT inclusive prices and then disappear without paying the VAT due to Customs.	1.77 to 2.75
	Traders failing to register to pay VAT where their turnover exceeds £56,000 a year. Some may operate in the shadow economy unknowingly but some do so deliberately.	0.4 to 0.5
	If implemented correctly VAT avoidance schemes are legal. Even so Customs do not consider it acceptable for businesses to use schemes which are artificial and have no other business purpose than to save VAT.	2.5 to 3
	Total	7.17 to 10.25

NOTE

The latest figures for bottom up estimates of loss were produced for 2001-02.

Source: HM Customs and Excise and the National Audit Office

How Customs are organised

1.12 In April 2001, Customs reorganised their activities to achieve a greater clarity and focus on their core activities of collecting taxes and duties and law enforcement. It was also aimed at creating an organisation that could respond more flexibly and quickly to emerging risks including fraud. Around 7,500 staff are employed in Business Services and Taxes on collecting and managing VAT. Some 600 staff in Law Enforcement are responsible for the intelligence, detection and investigation of VAT fraud. These are supported by staff in the support and infrastructure services division. Appendix 2 shows the organisational structure of Customs.

1.13 In July 2003 the Chancellor announced a major review of the organisations dealing with tax policy and administration, chaired by the Permanent Secretary to the Treasury, Gus O'Donnell. The primary purpose of the review is to make public service delivery more effective and efficient. It will examine the best organisational arrangements to achieve Government's tax objectives both now and into the future. In February 2004 the Government also announced a new single organised crime agency to start in 2006 incorporating the work of the National Crime Squad, National Criminal Intelligence Service and Customs' investigation and intelligence responsibilities for tackling serious drugs trafficking and related criminal finances. Customs' fiscal fraud investigation and intelligence responsibilities, including VAT fraud, will remain outside the new agency because of the essential links between that work and the rest of the tax system.



Part 2

Detecting, investigating and preventing fraud

2.1 This part of the report looks at how Customs detect, investigate and prevent VAT fraud.

Customs' assurance work on the VAT collected by traders

2.2 There are various reasons why large numbers of VAT registered businesses fail to pay the right amount of tax at the right time (**Figure 3**). At one end of the spectrum are businesses making mistakes on their VAT returns or failing to submit their returns on time. At the other end, it can involve businesses deliberately under-reporting their liabilities. Customs' experience suggests that there are thousands of ordinary businesses which are looking to gain financial advantages by deliberately under-declaring the amount of VAT due. There are also a relatively small number of traders who are carrying out more serious frauds.

2.3 Customs have found that distinguishing the reasons for underpayment between error and fraud is often not possible because of the difficulties and time it might take to prove the intention of traders. Research by Customs suggests that more than a third of the 1.7 million VAT registered traders may be under declaring their VAT

3 Examples of how VAT can be lost through non-compliance

Some traders:

- Have difficulties in understanding VAT and how it should be applied to their transactions and so make mistakes and careless errors;
- Try and obtain cash flow advantages by paying over the VAT to Customs after the due date;
- Do not submit their VAT returns and payments, or fail to pay VAT assessed by Customs when returns are not submitted by the due date;
- Pay VAT assessed by Customs in the full knowledge that the assessment does not accurately reflect their liability;
- Deliberately understate their liability in completing the VAT return and make an underpayment to Customs.

liability which they estimate results in net tax being lost in the range of £2.5 billion to £4 billion in 2001-02 (the latest figures available). In tackling the losses, Customs focus on delivering year on year improvements in the compliance of businesses with their obligations and on reducing the VAT gap. For example the accuracy of VAT declarations made by businesses has increased from 82.5 per cent in 2001-02 to 85.7 per cent in 2002-03.

2.4 In the Pre-Budget Report 2003, measures were announced to improve Customs' checks on the amount of VAT paid by businesses including:

- Targeting activity against traders and sectors that pose a significant threat to VAT revenue yield;
- Subjecting more large businesses with complex VAT arrangements to increased scrutiny;
- Performing more in-depth audits of selected cases;
- Increasing the number of checks performed prior to making repayments of VAT to businesses; and
- Reducing debt and increasing the rate of debt recovery.

2.5 Customs' programme of assurance checks on traders helps them to detect errors and provide a deterrent to fraud. They have differing approaches for large traders and small and medium traders. The 1,000 largest businesses in the UK are dealt with by the Department's Large Business Group. These businesses receive particular attention because of the sums involved and because the complexity of the companies' trading activities and accounting systems create a higher concentration of risks to the revenue than is found in the general trader population. Large businesses account for less than 0.1 per cent of the total trader population but around a third (£21.3 billion) of the total net VAT collected during 2002-03. Customs identified net additional liability of £1.06 billion from checks on large businesses in 2002-03.

2.6 Some 3,175 staff carry out assurance work on small and medium traders at a cost of £127 million a year. These staff identified net additional liability of £2.2 billion from their checks or a good return of £18.90 for every £1 spent. As part of their new VAT compliance strategy, Customs plan to implement targeted education of selected groups within the business community to increase awareness of the VAT regime and to encourage and support voluntary compliance with VAT regulations. Small and medium traders are selected for checks based on Customs' assessment of the risks each trader poses to the revenue (from low to exceptionally high risk). A central risk assessment categorises traders according to the risk of non-compliance. Customs' staff in regional offices use the results of the central risk assessment, combined with local intelligence, to select traders to include in the assurance programme and the type of assurance action required (a desk-based enquiry, phone call or visit to a trader). Their checks on selected traders are primarily aimed at ensuring that the correct amount of VAT has been paid over but can also act as a deterrent against fraud. The European Commission has encouraged the use of risk based approaches to assure the VAT revenue collected along the lines of the approach used by Customs, and a number of countries have learned from their approach.

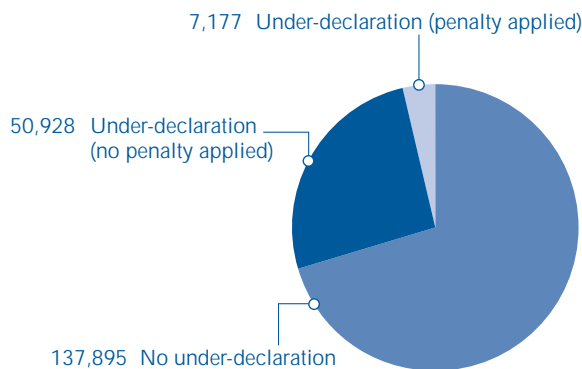
2.7 The Committee of Public Accounts in their 21st Report of Session 2002-03 concluded that in planning visits to traders, Customs should have regard not only to the risk of fraud and evasion, but also to the wider risk of misunderstanding even by compliant traders, and the need for advice and guidance as well as enforcement activity. The Committee saw scope for Customs to increase the revenue yield by visiting a significantly higher proportion of traders. In response Customs agreed that there is scope to increase revenue yield through increased contact with traders. This may be in the form of a visit or an office-based contact. In 2003, Customs launched a new approach to improve VAT yield and target activity more effectively across the full range of compliant and non-compliant businesses. As part of the new approach, Customs intend to contact all businesses within 12 months following registration, and ideally around the time the first VAT return is due. For those businesses that were registered before 1 April 2002 they plan to contact all of them by the end of 2004-05. Customs have also set up compliance management teams to offer guidance to businesses and educate them throughout their lifecycle. This should enable Customs to support and educate those who want to be compliant.

2.8 Customs imposed penalties in 7,177 or 12.3 per cent of cases where they had found under-declarations by large businesses and small and medium traders, amounting to a total of £20.1 million (Figure 4). A penalty may be applied when the errors found are greater than the statutory limits of 30 per cent of the gross amount of VAT or £1 million in VAT, and can be up to 15 per cent of the amount of VAT mis-declared. The misdeclarations may be due to clerical or bookkeeping errors or more persistent failures by the trader in calculating the amount of VAT. Customs will not impose a penalty where there is a reasonable explanation such as the trader made a mistake because of the complexity of the case, or because of compassionate circumstances or unforeseeable events which affected the business.

Customs' intelligence work on the risks to VAT

2.9 Customs have specialist intelligence staff who identify the business sectors and trader characteristics which present some of the greatest risks to the revenue. These staff also help to target organised crime groups involved in systematic VAT fraud. Since September 2002, Customs have been improving the value of their intelligence work by moving away from providing individual leads towards providing specific views of risks to the revenue and movements in risks over time at national, regional and local levels. They review regularly their resources to tackle fraud on each tax regime to ensure these are allocated to the priority areas set out in their individual strategies, and recognise that, as new information comes to light on the level of losses such as on VAT, they may need to change the allocations of resources.

4 Shows for 2002-03 the overall results from Customs' checks



Source: HM Customs and Excise and the National Audit Office

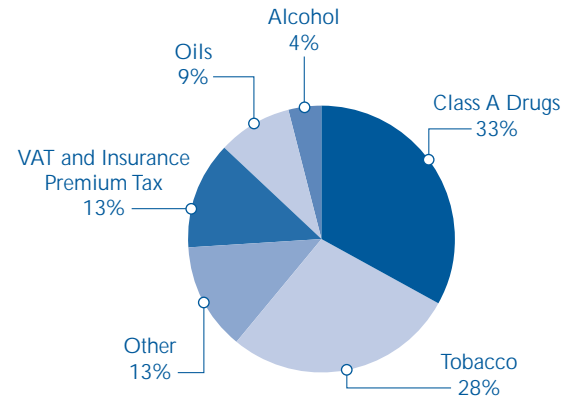
2.10 In 2002-03 Customs deployed 13 per cent of their intelligence resource on developing intelligence on VAT and Insurance Premium Tax fraud (Figure 5) and allocated around the same percentage in 2003-04. This is down from 16 per cent in 2001-02 because staff were redeployed onto higher impact work on tackling tobacco and drug smuggling and other VAT work. Intelligence also implemented structural and organisational improvements which enabled them to reduce the percentage of staff involved on tackling VAT fraud. The percentage of Intelligence staff involved on VAT work are under one half of those allocated to tobacco fraud. The difference is because tobacco smuggling intelligence work is more labour intensive compared to VAT, which is supported to a much greater extent by computer systems and can make greater use of data interrogation software and data analysis methods.

2.11 In Standard Report 2002-03 for HM Customs and Excise we found that in April 2001 Customs introduced an Intelligence Requirements Process which involves engagement with customers to determine the requirements for each of their strategies for tackling losses. The aim of this process is to specify precisely what Intelligence are contracted to deliver. It is underpinned by a raft of Intelligence Steering Groups. Our examination of their approach to tackling alcohol fraud demonstrated that this process falls short of achieving that aim. In particular, there is no specific process whereby the intelligence products are translated into the deployment decisions and resource allocations. Customs are looking at ways of addressing this weakness.

2.12 Intelligence staff use information from a wide range of different sources such as from Customs' staff in Business Services and Taxes, other government agencies, overseas law enforcement agencies, businesses and the general public to identify strategic and specific risks to the revenue and areas which need to be investigated further. An important source of information is that provided by traders on their VAT returns which can be compared with other information, such as trends in industry sectors, to identify areas for further examination. Intelligence staff use a number of computer applications and statistical methods to help them target fraud and suspicious transactions. Customs expect the introduction of e-business applications across their operations from 2005 to bring significant improvements in their analysis of the risks to the revenue and targeting of resources. Customs expect to see the benefits accruing from the e-business programme from 2005-06.

2.13 Customs have more limited access to information for assessing the risks to the revenue compared to tax collection authorities in some other EU Member States such as Belgium, the Netherlands, Spain, Sweden and Denmark, where direct and indirect taxes are collected by one agency and the information on taxpayers can be compared across different taxes. This is because the UK

5 Shows percentage of intelligence resource devoted to each area in 2002-03



Total intelligence staff: 1243

Total intelligence cost: £63.4 million

Source: HM Customs and Excise and the National Audit Office

Revenue Departments operate under separate legislation and have over the years developed information technology according to their individual responsibilities within that legal framework. Customs and the Inland Revenue share information about businesses under the authority of the Finance Act 1972 which allows disclosure of information between the Departments on matters relating to the performance of their duties.

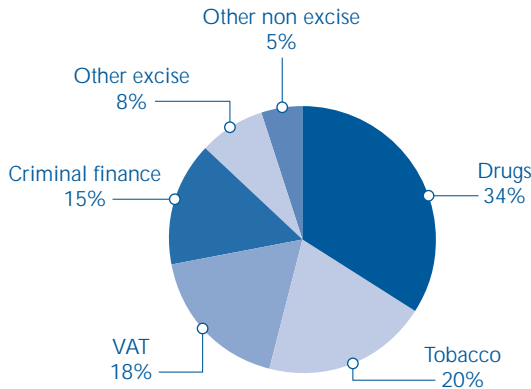
Customs' investigation and prosecution of VAT fraud

2.14 Customs have 1,800 investigation staff working on cases of fraud and smuggling at a cost of around £130 million a year. These staff investigate VAT fraud including missing trader fraud, frauds on Excise duties along with drugs smuggling and other prohibitions and restrictions, such as strategic exports. During 2002-03 these staff were investigating around 3,700 cases. Figure 6 shows that 18 per cent of staff time was spent on investigating VAT fraud.

2.15 In VAT fraud cases, Customs seek to:

- stop the fraud at the earliest opportunity; and
- impose a civil evasion penalty. Civil evasion penalties can be up to 100 per cent of the arrears, but Customs are permitted to reduce the penalty if traders cooperate during their investigations. The trader is expected to pay the arrears of VAT, the interest that is due and the penalty. Most cases of VAT fraud fall into this category; or
- prosecute a case criminally. This will depend on whether the circumstances fall within Customs' criteria for deciding on whether to prosecute (such as, whether the business was set up with the

6 Shows the percentage of time spent investigating each type of fraud during 2002-03



NOTE

All VAT criminal investigations have a parallel criminal financial investigation so a proportion of the criminal financial investigation resource is devoted to VAT related work.

Source: HM Customs and Excise and the National Audit Office

intention to carry out fraud, whether other criminal activities have occurred, and whether lawyers, accountants and others who advise on VAT matters are involved); and

- collect arrears and any penalties that are due to ensure that the economics of the crime are attacked. If this is not paid, they seek to recover assets from the individuals and businesses involved, sometimes through the use of insolvency legislation. Alternatively, in criminal cases Customs may recover assets as a result of a confiscation order issued by the court following conviction.

2.16 Customs' Solicitor's Office is responsible for prosecuting cases. In 2002-03 they had 58 solicitors working on prosecutions which cost £5.6 million. They were handling 2,841 prosecution cases of which 146 involved VAT fraud. The Butterfield report, published in July 2003, recommended that a separate prosecuting authority should be set up because prosecutors managed by the Customs' Solicitor were not seen to be sufficiently independent from investigation. It concluded that, although over the last few years there had been changes aimed at increasing the independence of prosecuting lawyers in Customs, these changes had not gone far enough. Customs' lawyers needed to be in a position to exercise their "minister of justice" role without fear or favour and needed to be seen by others as being in a position to do so. The Government has announced that an independent Customs and Excise Prosecutions Office will be set up during 2004 which will be directly accountable to the Attorney General (Figure 7).

7 Sets out events leading to the recommendation that a separate Prosecutions Office should be set up

In November 2002 The Chancellor of the Exchequer announced that in the light of the circumstances that led to the prosecution offering no evidence against 15 defendants in a case concerned with alleged conspiracy to cheat the public revenue of duty chargeable on spirits and beer he would be asking a High Court judge (Lord Butterfield):

- To consider the circumstances that led to the termination of those cases and, having regard to changes in relevant procedures and guidelines and to changes in practice within Customs that had taken effect since 1995;
- To review the practices of Customs in the recording, retention, revelation and disclosure of material which may be relevant to the prosecution of its criminal cases; and in respect of Customs' criminal investigations;
- To review current compliance with best practice in the use of investigation techniques and the management and control of cases to the extent these are relevant to the discharge of the prosecutions' obligations in any subsequent proceedings.

Civil investigation

2.17 In most cases where Customs suspect dishonest evasion of VAT, they look to impose a civil evasion penalty. The number of finalised cases where Customs applied civil evasion penalties fell sharply between 2000-01 and 2002-03 from 729 cases to 276 cases (Figure 8). The total value of cases also fell as a consequence, although the average amount of each case rose from £37,000 to £59,000 reflecting Customs' targeting of more serious cases. The trend also reflects the reallocation of staff to criminal investigations of missing trader fraud where the amounts involved are millions of pounds in each case.

8 Shows the average value of cases finalised under the civil evasion penalty procedure

Year	Number of cases where civil evasion penalties imposed	Average value of revenue evaded per case (£)	Total revenue evaded (£million)
1997-98	898	30,000	27
1998-99	902	33,000	30
1999-00	861	37,000	32
2000-01	729	37,000	27
2001-02	346	56,000	20
2002-03	276	59,000	16

Source: HM Customs and Excise

2.18 Prior to 2002 civil evasion cases were subject to a formal investigation. Customs found that these investigations were often as resource intensive for them and as stressful for traders as criminal investigations. As a consequence they have developed a less confrontational approach. In September 2000, Customs started a year long trial of the new procedures which were developed using existing legislation, best practice from existing procedures and those used by the Inland Revenue.

2.19 Under the new approach, Customs seek to reach agreement on the nature, extent and reason for irregularities. Meetings are held instead of formal taped interviews and, where traders agree to co-operate, no investigation is undertaken during the disclosure process. Customs' evaluation of the new approach showed that it is a more cost-effective way of dealing with many VAT cases (**Case study 1** and **Figure 9**). When arrears of VAT have been agreed and accepted by Customs and the trader has fully co-operated, any penalty imposed will not normally exceed 20 per cent of the tax evaded. Since 1 April 2002, Customs have been applying the new procedures nationally. The more formal standard civil investigation procedures are still used in cases where traders do not adopt the new procedures and in other cases where it is not appropriate, such as where VAT returns have not been rendered. While the number of civil evasion cases in 2002-03 did not reach pre 2001-02 levels, Customs are satisfied that their new approach will enable them to flexibly deploy staff to maximise the use of investigation resources in high risk areas.

2.20 From our analysis of cases investigated during 2002-03 we found that:

- Customs worked on almost twice the number of cases under civil evasion procedures (699 cases) than criminal cases (377 cases).
- The average amount of VAT involved in each case was much lower at £59,000 than the average on VAT criminal investigations at over £2.2 million.
- Around 55 per cent of civil investigations resulted in a levy of penalties (**Figure 10**).

CASE STUDY 1

Shows a civil evasion case which was settled quickly under Customs new civil evasion procedures

In October 2001 Customs launched an investigation into a trader who had been under-declaring his sales on his VAT return. The value of revenue evaded was estimated at £32,000. The trader fully cooperated and Customs imposed a penalty of £6,000, which was 20 per cent of the initial value of the arrears. The investigation was concluded in February 2002.

9 Shows the benefits of the new approach

Benefits for Customs:

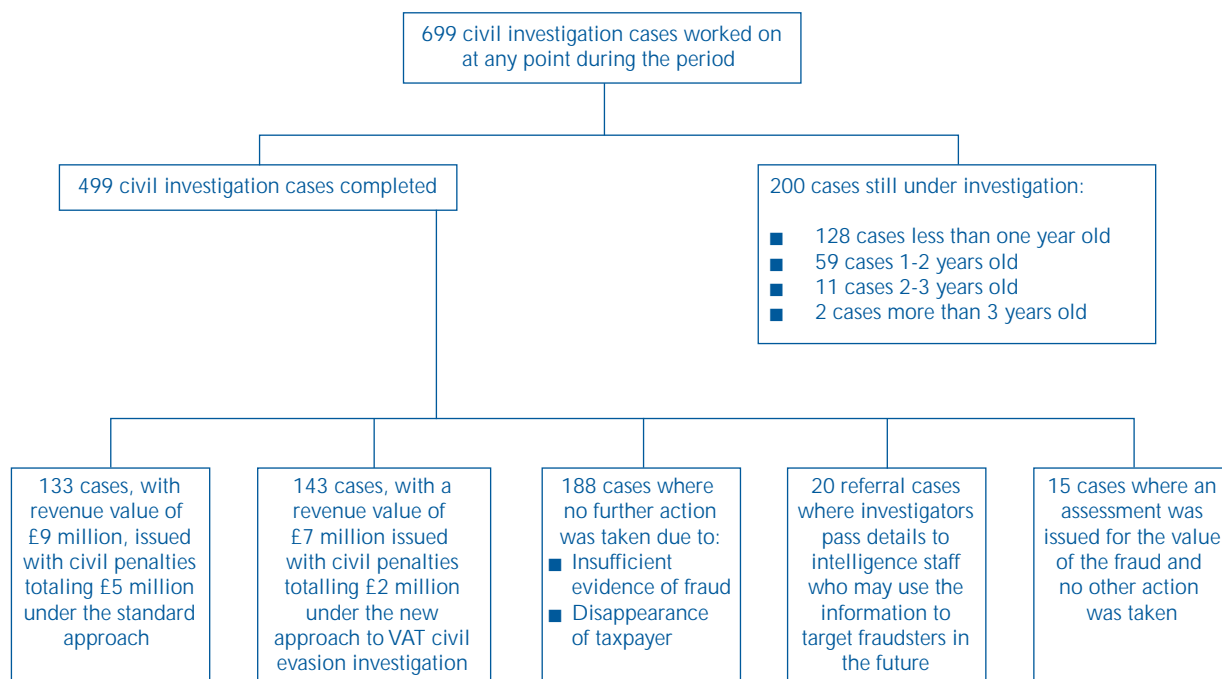
- More prompt payment of VAT arrears (the amount of arrears paid within three months increased from 32% to 75% and payments on account were made in 60% of cases)
- Increased efficiency (Customs case handling capacity doubled during the trial)
- A reduction in the number of appeals to the VAT and Duties Tribunal (there were no appeals during the trial period compared to an historic 8% appeal rate) and
- Increased opportunities to work more closely with Inland Revenue investigation teams. This is supported by a joint working protocol which lays down guidelines for investigators and management to ensure consistency of treatment for civil and criminal investigations.

Benefits for traders:

- A less adversarial approach
- Lower penalties (not exceeding 20 per cent of the tax evaded where they cooperate)
- No formal investigation during the period of disclosure or switching to criminal proceedings (although if a false disclosure is made, that can be the subject of a criminal charge)
- Opportunities for joint disclosure to Customs and the Inland Revenue.

Source: HM Customs and Excise

10 VAT civil evasion cases under investigation between April 2002 and March 2003



Source: National Audit Office analysis of HM Customs and Excise data

- Customs imposed civil penalties amounting to around £7 million in 276 cases representing over 40 per cent of the revenue evaded (Figure 10).
- The early indications are that the elapsed time to complete cases under the new civil evasion procedures is quicker at an average of nearly seven months compared with 11 months for those completed under the standard civil evasion procedures.

2.21 The Institute of Chartered Accountants told us that one of the lessons from the Inland Revenue's approach was their success in ensuring that taxpayers are treated consistently by exerting strong central oversight over all decisions. Beyond achieving the general principle of equity in treatment, this helps tax advisers advise taxpayers about how their affairs will be dealt with and encourages them in appropriate circumstances to voluntarily disclose any errors. Partly to ensure consistency, all investigation activity came under a single national management structure in a major departmental reorganisation in 2001. This was underpinned by the introduction of professional standards and common training for all. Customs have also issued guidelines to staff on the new civil evasion procedures and provided training for all investigators and have an assurance process in place to ensure that investigators adhere to the procedures. Customs have also given presentations and held meetings with major accountancy firms to explain the new approach to VAT civil evasion investigations.

VAT criminal investigations

2.22 Customs may investigate any case of suspected VAT fraud with a view to bringing criminal proceedings but, as a matter of policy, focus on the more serious or aggravated cases. For example, where the fraud involves the registration of one or more businesses whose activities are solely or primarily bogus or cases where professionals such as lawyers and accountants are involved. From 1999-2000 to 2002-03 the number of VAT fraud prosecutions finalised at court each year has remained reasonably constant at around 90 cases a year, with the exception of a significant fall during 2000-01 (Figure 11). Customs' new strategies for tackling VAT fraud, introduced from 2000 onwards, brought a tighter focus on targeting prosecution cases and disrupting frauds or dismantling organised crime groups.

11 Shows the number of VAT fraud prosecutions finalised at court

1999-2000	94
2000-01	37
2001-02	89
2002-03	86

Source: HM Customs and Excise

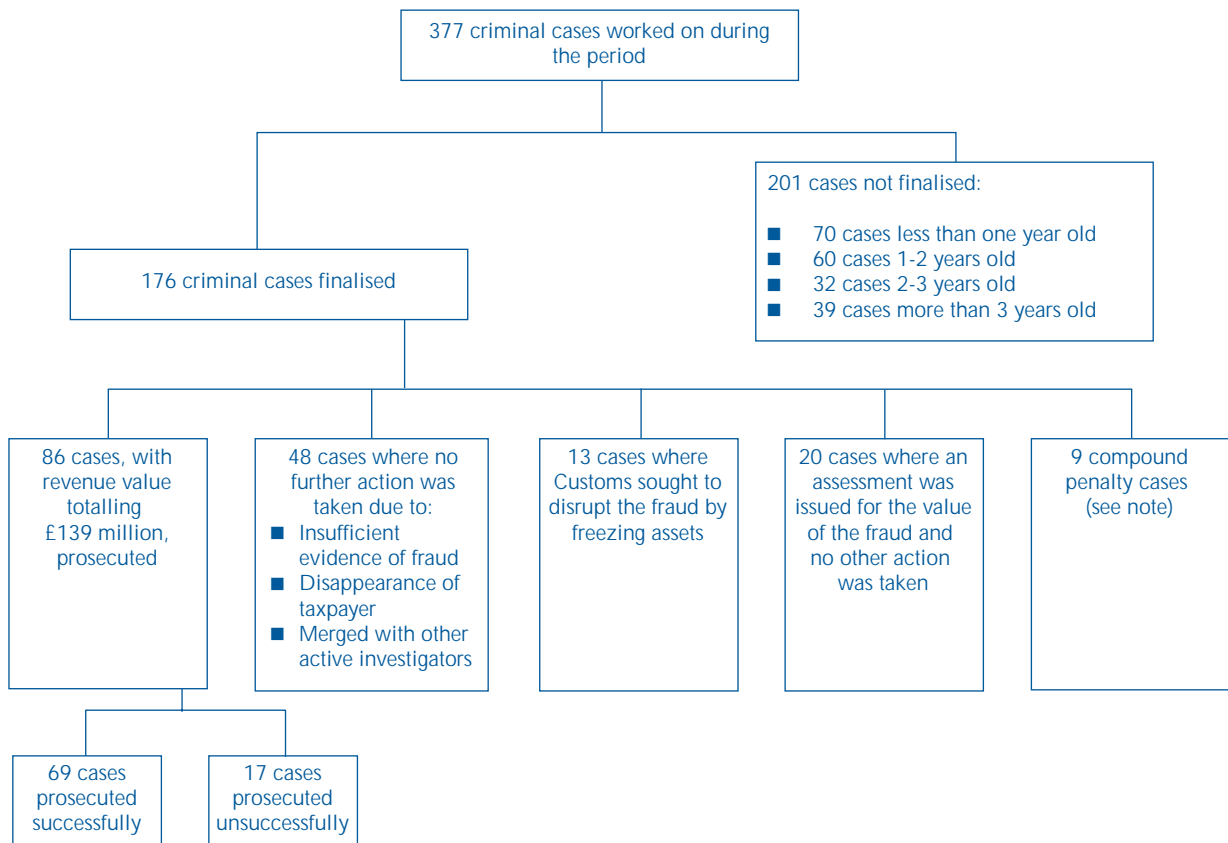
2.23 During 2002-03 Customs worked on 377 criminal cases of VAT fraud (Figure 12). Of the 176 cases finalised, 86 were prosecuted with a revenue value of £139 million of which 69 led to convictions. The 92 individuals involved in these cases received sentences ranging from nine months to six and a half years (the maximum sentence for VAT fraud is seven years). Fifteen of the cases prosecuted involved missing trader fraud (Part 3) of which seven cases led to convictions of 11 individuals.

2.24 We analysed the time taken by Customs to investigate and prosecute successfully 46 VAT fraud cases and found that these took an average of two years and eight months to complete with the shortest taking eight months and the longest five years and eleven months. Various factors can influence the time taken of which the complexity of the case and the amount of evidence that needs to be analysed and which needs to be prepared for court are significant (Case study 2). Customs find that courts are often not electronically equipped to present the significant volumes of documentary evidence making the process laborious for the jury. There are currently nine courts which have the facilities to present significant volumes of evidence

electronically. However, all courts can be used to present evidence electronically if prosecutors bring their own equipment. We found other factors impact on the length of time to complete a case where Customs are largely dependent on others such as:

- The need for Customs to make enquiries of authorities overseas can affect the time taken as they are dependent on timely responses to their requests for information (Case study 3).
- The availability of court time to hear a case. In some cases, due to circumstances outside their control, Customs may have to wait up to a year for the court time and lawyers to become available to try a complex case which then may last up to one year.
- Issues raised by the defence. For example the defence may claim that the defendants are too ill to stand trial and request postponements (Case study 3).
- Defendants pleading guilty on the eve of the trial or shortly after the start. Had those defendants pleaded guilty earlier the investigation could have been concluded more quickly. There is however little incentive, in terms of reduced sentence, for

12 Criminal investigations of fraud, including missing trader fraud, between April 2002 and March 2003



NOTE

A compound penalty is normally a multiple of the duty evaded and can be issued as an alternative to criminal prosecution.

Source: National Audit Office analysis of HM Customs and Excise data

defendants to do so, as they will usually receive the same discount to their sentence regardless of how late in the process they make a plea (**Case study 4**).

2.25 In 48 cases Customs decided not to take any further action, for example because:

- there was insufficient evidence to prosecute; or
- the defendants absconded to a country with which the UK does not have an extradition treaty (**Case study 5**); or

- common links were established between these and other active investigations resulting in the merger of cases.

2.26 Customs have 42 teams investigating VAT fraud cases. They consider that the optimum size for a team is 12 investigators reporting to a manager. Each team works on an average of five cases at different stages, from pre-knock (prior to any arrests being made) through to appeal. A case will remain with a team until all stages are complete. Two twinned teams investigate the larger

CASE STUDY 2

Some complexities that may be involved in investigating and prosecuting a case

Customs received information indicating that individuals in the Dover area and in Luxembourg were running several companies which could be involved with VAT missing trader fraud. Customs "knocked" (the date when the suspects are arrested and evidence is seized) the operation after investigating the fraudsters' activities for six months. They searched 20 premises, arrested 10 individuals and seized thousands of documents. The trial of eight of the individuals commenced a year later and lasted for nine months. Six of the eight defendants were convicted and were given sentences totalling 25 years. After the trial the judge issued confiscation orders of £50 million.

CASE STUDY 3

A case where overseas inquiries were made and where issues raised by the defence influenced the amount of time taken

In March 1997 Customs started an investigation into a UK based individual who was purchasing computer parts from an Israeli criminal based in Belgium via two other UK companies. The UK companies did not pay over to Customs the VAT due on the sales. Payments for the computer parts were made to a Belgian bank in the name of a trader based in Ireland who was also involved in the fraud. The proceeds from the fraud were then laundered and sent to Israel.

Because of other priorities, the fraud was not "knocked" until May 1999 when three people were arrested and 150 boxes of evidence and seven computers were seized. To collect evidence for the trial Customs staff had to make enquiries in Ireland, Belgium, Luxembourg, the Netherlands and the Isle of Man.

Two defendants appeared in court in June 2000 and the trial date was set for June 2001. The trial was put back six months at the request of the defence and when it started in January 2002 the defence asked for the proceedings to be halted after five days because one of the defendants was ill. The defendants were eventually tried separately. The jury were unable to reach a verdict on the first defendant but he was found guilty at a re-trial in September 2002. The second defendant, for whom the original trial had been postponed, pleaded guilty on the second day of his trial, also in September 2002.

more complex cases. There is a risk that the more complex cases can lead to the other cases receiving less attention but this is addressed by managers reviewing progress and by brigading resources. Another possibility would be for Customs to allocate only one complex case to a team while others might handle more of the less complicated ones. There could be additional costs with this approach which may be worthwhile if cases could be progressed more quickly.

2.27 Customs introduced a new national standardised case handling and management system in September 2001 to monitor the progress of each case under investigation. It records details of each case including when the

investigation started, when it was concluded, and the outcome, including the value of confiscation orders sought and obtained from the courts. Customs have other management information systems that detail all cases on hand, the throughput rate and the outcomes. These systems also give a picture of the costs of investigations by tax regime, region, branch and team. Customs use the information systems to monitor effectiveness, resource utilisation and spend against budget.

2.28 Fraud investigators are mainly recruited from staff from other areas of Customs such as auditing VAT traders. They also recruit staff from a wide range of backgrounds including the police, the military, school leavers and

CASE STUDY 4

A case where the defendant changed his plea

In April 1997 Customs opened an investigation into an individual who was abusing a "cash accounting" scheme by using false invoices and customers. This individual was also "pyramid" selling the fraud to others and inviting them to become members of a syndicate that paid over part of its fraudulently earned profits to him. Customs estimate the defendant's fraudulent activity was worth approximately £662,000. When Customs knocked the operation in November 1997 they arrested three individuals and seized approximately 50 boxes of paperwork and three computers.

The defendant appeared in court in May 1999 but there were several delays because the defence claimed that the principal defendant was unfit to stand trial because of psychiatric problems. The judge ruled that he was fit to stand trial. The defence then claimed that there had been an abuse of legal process by Customs but in September 2000 the court ruled that this was not the case. The trial commenced in January 2001 and on the first day of the trial the principal defendant changed his plea to guilty. However, he later changed his plea again and only admitted to a minimal level of guilt. In May 2001 a change of plea hearing was held at which the court ruled in Customs' favour and the defendant was convicted and sentenced to two and a half years. There was subsequently a financial hearing at which a confiscation order of approximately £210,000 was awarded and the defendant was asked to pay £15,000 in costs as compensation for delaying the legal process.

CASE STUDY 5

A case where Customs raised an assessment and where the suspect moved to another country with which the UK does not have an extradition treaty

During a local VAT office visit to a company selling mobile phones Customs' staff identified anomalies which raised their suspicions. They were unconvinced by the trader's claim that he had exported mobile phones to companies outside the UK on which he had not charged VAT. Customs' staff believed that he had sold the mobile phones in the UK and intended to reclaim from Customs the VAT which he had paid to his suppliers. Customs raised an assessment of £1 million for the VAT owing and also placed a restriction on the trader's VAT account to stop him reclaiming VAT from them.

Four months later, Customs' investigations indicated that the company was involved in VAT missing trader fraud. The company's owner was a Swedish national who spent long periods of time outside of the UK. During the course of the investigation the individual moved to Thailand, a country with which the UK does not have an extradition treaty, and the case has been suspended pending the trader's reappearance in the UK.

university graduates who can earn over £30,000 a year on joining. It is important that Customs' investigators are equipped with the right skills and competencies for investigation work to ensure that evidence requirements and legal procedures are properly followed. New recruits are given 26 weeks of training in basic investigation techniques which can be followed by more specialist courses such as the handling of informants. The Butterfield report found that the basic training provided to investigators is reasonably thorough and is regularly updated but that subsequent training is somewhat ad hoc and not systematic. It recommended that improvements should be made. Customs are now in the process of introducing National Occupational Standards. In common with other Law Enforcement Agencies future training will be geared to meet the standards set by the Police Skills and Standards Organisation. The Standards will be used as the basis of accredited training to professionalise investigation work. In other Departments such as the Inland Revenue and the Department for Work and Pensions there has been a move towards university accredited training to help improve the standard of criminal code investigations.

- 2.29 On the more technical aspects of the work investigators are supported by specialists such as forensic accountants and computer analysts when required. The Butterfield report recommended that they should be provided with more dedicated expert legal advice to help improve the quality of cases that reach the new prosecuting authority (paragraph 2.16). The report recommends that Customs' investigations should be subject to systematic external scrutiny and that a further study should be undertaken to determine how this should be introduced.

Confiscating assets to recover the revenue lost

- 2.30 Where Customs prosecute fraudsters successfully they seek to recover the full benefits obtained from criminal conduct, including the tax evaded, through the use of confiscation orders. These are often used in conjunction with a restraint order to prevent the removal of the defendants' assets and to preserve their value for the purposes of meeting a confiscation order. As part of an investigation, Customs look into the financial affairs of the suspected fraudster to provide the evidence needed by the court to determine the extent of the benefit obtained by the defendant, and to make a confiscation order. The confiscation order may be for less than the revenue benefit assessed by Customs because the courts will take into account the amount that can be realised from the assets of the fraudster (**Case study 6**). If the confiscation order is not paid the defendant may be given an additional sentence of up to 10 years. Customs consider that confiscation orders and the imposition of default sentences can be a powerful deterrent to fraudsters. Nevertheless, some are willing to serve prison sentences rather than be parted from their assets.

CASE STUDY 6

A case where Customs used a confiscation order against a person who had been convicted of VAT fraud

In February 2002 a person in a VAT fraud case was convicted and sentenced to 6 ½ years in prison. Customs estimated that the value of the benefit that the trader had gained from the fraud was £19.8 million. The courts, taking into account the total defendant's assets, set the value of the confiscation order at £183,869. The courts also issued a default sentence of two years and six months which the principal has to serve if he is unable to pay the value of the confiscation order. Customs were able to collect £143,861 of the confiscation order, as the court was subsequently satisfied that this was the extent of the person's realisable assets.

- 2.31 The enforcement of a confiscation order involves a complex legal process. Up to December 2002, Customs' responsibilities within the process were undertaken by the Asset Forfeiture Unit, a dedicated unit of eight lawyers and 11 support staff within the Solicitor's Office. Their work included preventing the dissipation of assets before conviction, undertaking all work in connection with court proceedings arising from confiscation cases, and dealing with all aspects of the enforcement process that fall to the prosecutor, including the appointment of receivers. The Magistrates' Courts are also responsible for the enforcement of confiscation orders. From December 2002, the Task Force on Enforcement of Confiscation Orders was set up under the Home Office which brings together the work currently undertaken by Customs and the Crown Prosecution Service in relation to orders made under the Drug Trafficking Act 1994 and the Criminal Justice Act 1988. The aim is to speed up the recovery of assets where confiscation orders have already been obtained.

- 2.32 At the end of 2002 the Asset Forfeiture Unit were handling 330 confiscation orders with a value of £59 million which included drugs cases and frauds on indirect duties. During 2002-03 £13 million was collected against these orders. The Unit estimated that overall they recovered around half of the amount set out in the confiscation orders. They collected less than the full amount in some cases because:

- where the Unit appoint a receiver the costs are met from the amount recovered. These costs may exceed the amounts involved but Customs consider that these expenses are worthwhile if the criminal is deprived of the proceeds of their crime;
- when the confiscation order is made the court does not take into account any other claim on the assets which may only emerge when Customs seek to enforce the order;
- the fraudster may hide the assets and refuse to help with locating them. In these cases the fraudster may be given an additional sentence.

2.33 It can take many years to recover the assets because:

- the convicted person through their representatives will not reply as to how the confiscation will be settled or will say that they cannot afford to pay the amount due;
- the courts may give the convicted person time to pay of three to five years;
- the convicted person may appeal against the order when the Unit try to enforce it;
- the convicted person may be given an additional sentence because they have refused to settle the confiscation order. However this does not absolve them from settling the order. The Unit may monitor whether they are able to realise the assets to further enforce the order.

2.34 To help speed up the recovery of assets Customs have entered into a protocol with the Department for Constitutional Affairs, the Magistrates' Courts and the Crown Prosecution Service on how they need to cooperate to enforce confiscation orders, including the timing of action by each party at each stage of the process. The Task Force on Enforcement of Confiscation Orders is providing advice to courts on the confiscation of assets and has produced a best practice guide.

2.35 The powers of Customs and other law enforcement agencies to take action to deprive criminals of their assets have increased substantially as a result of the Proceeds of Crime Act, which received Royal Assent in July 2002. The legislation also led to the setting up of the Assets Recovery Agency to investigate and recover assets accumulated through criminal activity. Working closely with law enforcement agencies, the Agency will be charged with increasing the priority given to financial investigation and asset recovery. From February 2003, the newly created Assets Recovery Agency has been taking on cases from Customs and the Police for civil recovery of assets where a criminal investigation has been carried out but it has proved impossible to

continue with the criminal case, and consequently there is no possibility of obtaining a confiscation order (which is dependent on conviction). The new civil recovery scheme enables the Director of the Assets Recovery Agency to sue in the High Court for the recovery of the proceeds of unlawful conduct without the need for any body to have been convicted of an offence. The Agency also has the option to tax the proceeds of crime where there are reasonable grounds to suspect that a person's income, profit or gain was derived from crime. Customs also have increased powers under the legislation to carry out financial investigations and recover assets and work in co-operation with the Assets Recovery Agency (Figure 13). Customs consider that the new powers will be a powerful weapon to combat the activities of organised crime.

2.36 The National Criminal Intelligence Service believes that criminal groups are likely to respond to the new legislation by intermingling legitimate and criminal funds through established businesses to confuse the audit trail and by placing more assets overseas (Figure 14 illustrates criminals' responses to the creation of a Criminal Asset Recovery Bureau in the Republic of Ireland). Criminals may also make more attempts to corrupt and coerce staff of financial institutions, make greater use of money laundering experts or professionals such as solicitors and accountants, or target more crimes at funds already in the mainstream banking system.

13 Summarises Customs' new powers of confiscation and asset recovery

Seize cash or equivalent monetary instruments which are suspected of being crime related anywhere in the UK. Previous powers restricted seizure to drugs related cash found at import/export. Customs obtained forfeiture orders of nearly £5 million of suspected drug related cash in 2001-02 and over £6 million in 2002-03.

Restrain money and assets at the start of a criminal investigation using orders from Crown Courts rather than the High Court. This will make it more difficult for criminals to hide assets.

Secure convictions for money laundering more easily as Customs will now only have to prove that laundered money was the proceeds of crime and not that it came from a specific offence or class of offences.

Develop better intelligence to inform criminal investigations through the strengthening of the obligations on businesses in the financial sector to disclose suspicious transactions.

Enhance the effectiveness of Customs' investigations by seeking court orders requiring banks etc. to identify accounts of people under investigation and provide information on suspect accounts.

Preventing fraud

2.37 Customs' estimates of the level of fraud and the trends in those figures help them to determine whether controls should be strengthened to prevent further losses. In doing so Customs consider their administrative costs involved in tightening controls and the additional costs to businesses of complying. The actions they take to strengthen controls depend on the type of fraud being committed and where the losses are occurring in the system. For example Part 3 sets out how Customs have strengthened controls to prevent potential missing traders from registering with them.

2.38 As part of their new VAT strategy, Customs are trying to distinguish more clearly between those businesses which have genuine difficulty understanding and complying with the VAT rules, and those which deliberately bend or break those rules. To help businesses that want to comply Customs are providing more guidance and advice, tailored to meet specific businesses' needs, and undertaking more frequent contact to identify potential problems early and offer solutions. The guidance should also help to prevent businesses entering into the shadow economy as they will be more aware of the legal requirements to register for VAT. Part 4 looks at Customs' approach to tackling the shadow economy. We noted that some other EU Member States have been using publicity campaigns to encourage taxpayer compliance and the results of these campaigns could inform Customs' approach as they implement their publicity strategy to encourage tax compliance (Figure 15). For those businesses which are persistently non compliant, Customs are seeking to increase the likelihood of detection and recovery of arrears. They also intend to increase follow up action to ensure businesses remain compliant.

14 The experience of the Republic of Ireland in recovering criminal assets

In the Republic of Ireland, the introduction of a Criminal Asset Recovery Bureau led to a number of criminals leaving the country and others adjusting their lifestyle. Some crime groups also continued to direct operations in the Republic from overseas.

15 The use of media in the Netherlands

The media is used to a greater extent to promote the image of the tax authorities and to encourage tax compliance. Media campaign strategies are used to target certain groups to influence their behaviour. There is normally one national campaign each year and four smaller campaigns that target particular sectors or types of business.

Part 3

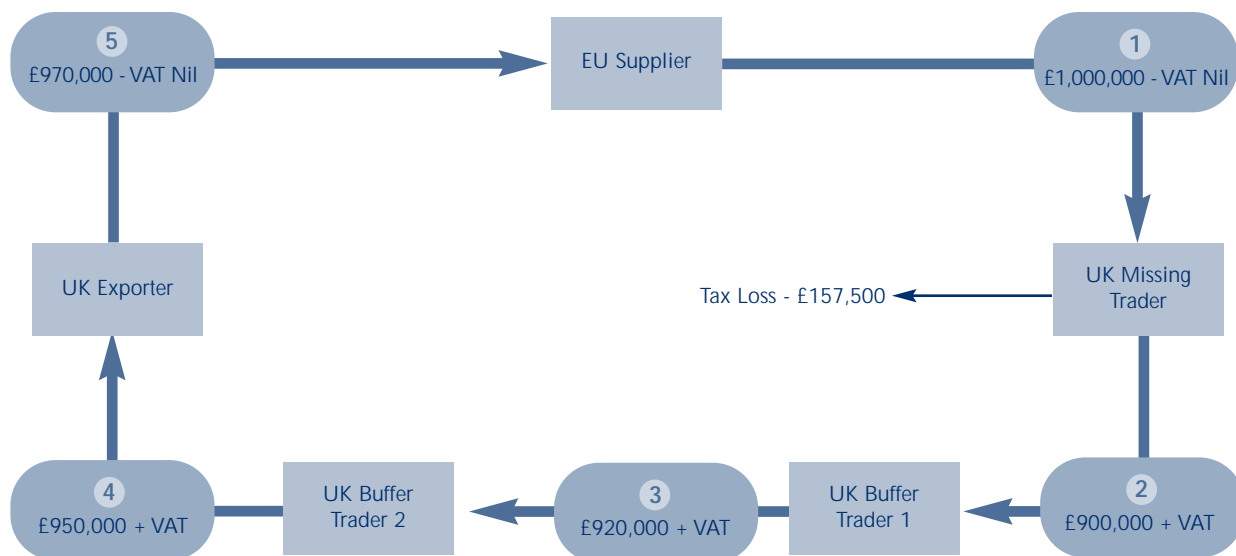
Tackling VAT Missing Trader Intra-Community Fraud

How fraudsters take advantage of EU arrangements to steal VAT

- 3.1 This part of the report examines how Customs tackle the most serious type of fraud known as VAT missing trader intra-Community fraud. This fraud involves a fraudster obtaining a VAT registration number in the UK for the purposes of purchasing goods free from VAT in another EU Member State, selling them at a VAT inclusive purchase price in the UK (sometimes to a legitimate VAT registered trader who can reclaim the VAT on the purchase) and then go missing without paying to Customs the VAT due leaving the goods available on the home market for consumption. By stealing VAT in this way, the fraudster is able to undercut honest businesses and sell goods at a paper loss. The more common and lucrative variant is carousel fraud where, instead of being sold for consumption on the home market, goods are sold through a series of contrived transactions before being sold to a trader in another Member State who then sells the goods back to the UK (Figure 16). This allows the fraudsters to carry out the fraud repeatedly using the same goods.
- 3.2 Missing trader frauds exploit the European Community's 'transitional' VAT system supply and acquisition arrangements, which were introduced in 1993 as part of the creation of the Single Market (Figure 17). Under these arrangements, if a VAT registered business in the UK purchases goods from a VAT registered trader in another EU Member State, they do not pay VAT on the purchase in that Member State but are obliged to charge and account for VAT at the UK rate if they sell the goods on to a buyer in the UK. This system is designed to ensure that VAT is paid in the Member State where the goods are 'consumed'. However, fraudulent traders exploit this system by charging and collecting VAT on onward sales of the goods they obtained 'VAT free' and then closing down their operations and disappearing without paying the VAT due to Customs.
- 3.3 The transitional system was only meant to be in place until 31 December 1996 when it was to be replaced by a final or 'definitive' system based on the principle of VAT being levied in the Member State where supplies originated. However, the transitional arrangements have continued in the absence of any agreement by Member States on a definitive system.
- 3.4 In the European Commission's view the introduction of a definitive system would remove the opportunity for the current type of missing trader fraud on intra-Community trade. Even with the definitive system, missing trader fraud would still be a risk wherever goods could be obtained VAT free. This would apply to goods destined for export from the EU which could be illegally diverted, or where a high value commodity, with a ready market, could be obtained at a nil or low rate of tax outside of the EU and then smuggled across EU borders. The replacement system could also prompt missing trader fraudsters to look for other opportunities to defraud, such as repayment frauds using false invoices from Member States. The European Commission has found little support among Member States for the wholesale reform of the VAT system along these lines. So in June 2000, they launched a five year programme to improve the operation of the present system. One strand of this is the fight against VAT fraud. The Commission published a review of progress in 2002-03 which concluded that the existing system would continue to be modernised to ensure that it is more uniformly applied. With increasing cooperation among Member States and backing from the Commission the review states that it should be possible to keep fraud within acceptable limits. The UK and some other Member States have accordingly developed their own strategies within the existing overall framework.

16 How fraudsters carry out VAT missing trader frauds

Simple VAT Missing trader 'carousel fraud'



- 1 The missing trader purchases goods (typically mobile phones or computer components) from a supplier in another EU Member State. Supplies between VAT registered businesses in EU Member States are zero rated for VAT purposes.
- 2 The missing trader then sells the goods to another UK trader, a buffer company. (Buffer companies are introduced into the supply chains to create the appearance of legitimacy and to hinder Customs' investigations). The fraud occurs when the missing trader closes down its operations after a period of intense trading and disappears without paying over to Customs the VAT the buffer company has paid.
- 3 The buffer company accounts for VAT in the correct way and sells the goods on to a further buffer company which also accounts for VAT correctly (in practice there can be upwards of 12 buffer companies in a supply chain).
- 4 The final buffer company sells the goods to an exporter who makes an onward zero-rated supply back to the company in the other EU Member State which originally supplied the goods. The exporter then claims a refund of the VAT it has paid from Customs.
- 5 The EU supplier has bought back the same goods it supplied at a profit and the chain of transactions recommences.

Source: HM Customs and Excise

17 The main characteristics of the transitional scheme

- The objective of the EC transitional VAT regime is to ensure that goods which are supplied from one Member State to another by VAT registered businesses are taxed in the Member State of consumption.
- The terms export and import were abolished when referring to trade between Member States. Intra-Community supplies of goods (formerly exports) are exempt from VAT in the Member State of origin provided that the purchaser is registered for VAT in another Member State and the goods are removed from the Member State of the supplier. Intra-Community acquisitions of goods (formerly imports) are taxable in the Member State where they are to be consumed and have to be declared by the purchaser in their periodic VAT returns.
- To compensate for the removal of customs formalities and checks at the border, and to try and prevent losses of tax revenue, the tax administrations of each Member State are required to operate a computerised system for the exchange of VAT information called the VAT Information and Exchange System (VIES). This system is used to both verify whether or not a business is properly registered for VAT in another Member State and to validate the value of intra-Community supplies and acquisitions between VAT registered businesses.
- These arrangements are only for VAT registered businesses. Consumers pay VAT at the point of origin on goods purchased in another Member State without any further formalities.

Customs' action to tackle VAT missing trader fraud

3.5 Customs became concerned about missing trader fraud in 1999. Their intelligence work suggests that a relatively small number of fraudsters are involved in undertaking this kind of fraud, with their activities accounting for over a fifth of the £11.9 billion estimated revenue loss on VAT during 2002-03. Individual cases of missing trader fraud often involve losses of several million pounds a week (**Case study 7**). These frauds are often perpetrated by organised criminal gangs trading in large quantities of high value/low bulk products, primarily mobile telephones and computer equipment. Other EU Member States also suffer from this type of fraud but on a wider range of goods such as cars.

3.6 In September 2000 Customs introduced a strategy for tackling missing trader fraud. Their approach built upon measures used successfully by Belgium and the Netherlands (see **Figure 18**). Customs' approach includes:

- Preventing potential fraudsters from registering for VAT which will deny them the opportunity to carry out the frauds.

CASE STUDY 7

The amount of VAT that can be stolen in an individual case is large

In November 2002, a man was arrested and charged with conspiracy to cheat the public revenue in respect of an alleged VAT missing trader fraud amounting to more than £300 million. This was a joint operation between HM Customs & Excise and the Criminal Assets Bureau/An Garda Síochána and Revenue Officers of Customs and Excise Enforcement in the Republic of Ireland. The Bureau obtained freezing orders in the Republic of Ireland for assets valued at approximately £20 million and HM Customs & Excise have restrained assets valued at over £12 million.

18 Shows the approach in Belgium and the Netherlands

Belgium has had a problem with 'carousel fraud' for many years because of their system of taxes before the introduction of the Single Market. The main sectors for carousel fraud are mobile phones, computer components, petroleum and textile industries. In 1998 the tax authority set up a team specifically to target this type of fraud. Their approach was to closely monitor known exporters of goods used in committing this type of fraud and their customers.

The Netherlands set up a carousel fraud unit in 1998. By the end of 1999 the tax authorities considered that the problem of this type of fraud in the computer component industry had been successfully tackled. Their strategy focused primarily on identifying those firms which were committing the fraud.

19 Shows Customs' estimates of VAT missing trader fraud

Year	Lower estimate £billion	Upper estimate £billion
2000-2001	1.39	2.62
2001-2002	1.77	2.75
2002-2003	1.65	2.64

Source: HM Customs and Excise

- Where fraudsters have successfully registered, identifying them, disrupting their activities at the earliest opportunity, investigating them, prosecuting where appropriate and taking action to recover the VAT that may have been lost.
 - Disrupting the activities of fraudsters by discouraging legitimate businesses from trading with them.
 - Tightening up on established traders reclaiming VAT on purchases from suspect suppliers.
- 3.7 In *Tackling Indirect Tax Fraud* published in November 2001, Customs set out to halve the scale of the losses through these measures and produce an annual saving of at least £750 million by 31 March 2004. Customs latest estimates show that losses from missing trader fraud have stabilised and are starting to decline (**Figure 19**). Before September 2000 losses were growing at around £450 million to £750 million a year. There are now over 450 Customs' staff tackling missing trader fraud. Building on the existing strategy, Customs are increasing the level of their checks to prevent bogus traders from registering, undertaking more rapid investigations of traders in high risk sectors to identify and stop existing frauds more quickly, and increasing their efforts to recover VAT losses from detected fraudsters.

Preventing missing trader fraud

3.8 Customs registration staff carry out checks on all applications to register for VAT, including comparing information provided by applicants against risk criteria to identify potential fraudsters. Automatic computer checks are also carried out on the information provided including validation against internal and external databases. Suspect applications are referred to law enforcement staff who carry out further checks. To help improve these checks, Customs introduced a revised application form for VAT in January 2002 which requires traders to supply more information than previously, such as details of any previous business activities for all partners and directors and the home address and National Insurance number of partners, sole proprietors and the application signatories for companies. During 2002-03, registration staff referred around 2.8 per cent of all applications for further checks resulting in 914 applications showing the hallmarks of VAT missing trader fraud being refused, which represented less than one half of one per cent of all applications to register (**Case study 8**).

3.9 Customs can apply conditions if they have concerns about applications but there are insufficient grounds to refuse registration. These conditions can include requiring the trader to provide financial security, submit their first VAT return early and subsequent returns monthly instead of quarterly and preventing repayments of VAT until further checks are carried out. During 2002-03, Customs received 257,139 applications to register of which just over one per cent were granted with conditions due to concerns about possible fraud. Customs also apply conditions on traders for reasons which are not related to concerns about missing trader fraud.

Detecting missing trader fraud

3.10 To help identify fraudsters who have obtained a VAT number to carry out a missing trader fraud, Customs use information from a number of sources including other traders and law enforcement agencies. Customs' staff also carry out post registration visits to those they consider may be involved in missing trader fraud.

3.11 Where Customs detect a case they will seek to:

- de-register the company so that it cannot continue trading and steal VAT. In 2002-03 Customs identified and de-registered 1,225 existing missing traders;
- obtain 'freezing orders' on companies' bank accounts. The value of injunctions secured in 2002-03 was £24.9 million;

CASE STUDY 8

A case where Customs' checks led to a fraud being prevented

The brother of a fraudster involved in a missing trader case investigated by Customs applied to register a company that bought and sold computer parts. On further enquiry Customs found that the man had no knowledge of the computer components industry, was unable to demonstrate he would be making taxable supplies, was unable to provide details of customers and suppliers and had no sources of funding to run the business. They refused to register the company. Customs estimate that their actions prevented losses of £4 million.

- raise an assessment for the VAT owed and seek to recover the money. During 2002-03, Customs issued assessments to missing traders for unpaid VAT totalling £670 million, which was equivalent to between 24 per cent and 39 per cent of the total estimated loss from missing trader fraud during the year. However, missing trader fraudsters arrange their financial affairs in ways which are designed to hamper Customs' efforts to recover the amount lost. During 2002-03, Customs wrote off £634 million in missing trader debts amounting to 35 per cent of all debts written off in that year. Customs have set up specialist debt management teams to pursue recovery through the appointment of liquidators or receivers utilising insolvency legislation to recover the personal assets of individuals involved in this type of fraud;
- prosecute those involved wherever appropriate (see paragraph 2.22). During 2002-03, Customs finalised investigations into 45 missing trader frauds and merged a further seven with other active investigations. Fifteen of these cases, with a revenue value of approximately £85 million, were prosecuted and seven resulted in convictions. Customs are currently working on around 100 ongoing missing trader fraud criminal cases involving VAT totalling some £2 billion with over 80 of these cases awaiting trial.

3.12 Customs have challenged repayments of VAT to the exporters in the UK who they suspect have purchased goods in a supply chain involving a missing trader. Where there has been sufficient evidence to show that the exporter was either in collaboration with the missing trader or has not been engaged in a genuine economic activity, or where the exporter does not hold a valid tax invoice or evidence to support the zero rating of their exports, they are able to deny repayment. They are currently withholding VAT repayments amounting to tens of millions of pounds while they verify the legitimacy of certain repayments. In April 2003 a VAT and Duties Tribunal decision confirmed Customs could deny VAT repayment claims where the transactions do not amount to an economic activity. From April 2003, Customs can also:

- require businesses to provide financial security as a condition of continuing to trade where they trade consistently in supply chains involving missing traders. The amount of security is usually equivalent to potential VAT losses from a supply chain in which the business trades. This will enable Customs to protect the revenue at risk both from businesses where the involvement in fraudulent trading is complicit and those which are turning a blind eye to fraud;
- stop businesses that trade in computers, telephones and other specified goods from reclaiming the VAT paid to their suppliers if they do not have a valid invoice and cannot provide further evidence to show the transaction is bona fide;
- make businesses trading in telephones and computer components jointly and severally liable for VAT due from missing traders in a supply chain where that business knew or had reasonable grounds to suspect that the VAT on the supply of those goods would go unpaid.

The German and Dutch authorities have also recently put legislation in place to pass missing traders' VAT liabilities on to other traders in the chain who are suspected of being involved in the fraud.

3.13 To help them identify potential fraudsters Customs use information on suspicious transactions notified to the National Criminal Intelligence Service (NCIS) by financial institutions and others including professionals such as accountants and solicitors. NCIS provide tactical and strategic intelligence to Government Departments on serious and organised crime nationally and internationally. NCIS have been concerned that they have not received as many notifications as they expected but in 2002 notifications increased by more than 70 per cent in response to more stringent reporting requirements since September 2001. The Proceeds of Crime Act 2002 has increased the obligations on financial institutions to report suspicious transactions. NCIS have set up a unit which is specifically tasked with

processing those financial disclosures that may indicate VAT missing trader fraud. Their reports help with earlier identification of frauds and provide important information for existing investigations.

3.14 To improve the flow of relevant financial information Customs have been working with the main financial institutions to gain their cooperation and have explained the signs to look for in identifying suspicious transactions which could indicate VAT missing trader fraud. Customs have extended the education programme to those institutions and professionals who in the past do not appear to have been reporting many suspicious transactions, or to those identified as favoured by the fraudster.

3.15 Cooperating with other EU Member States can also help with identifying cases of VAT missing trader fraud, since the fraudsters will be operating through another EU country to carry out the fraud. One mechanism which facilitates this is a computerised system for automatically exchanging information about VAT registered traders and the value of their intra-Community supplies of goods (known as the VAT Information Exchange System, or VIES). This system was introduced in 1993 to compensate for the abolition of customs checks at the borders and prevent losses of tax revenue when the current VAT system came into effect. The value of VIES in tackling missing trader fraud can be limited as the data on the transactions is at least three months old, and some traders do not record transactions on the system or they record them incorrectly. Tax authorities in Member States can use the data or any other intelligence to make enquiries of each other on transactions and traders. Member States have up to three months to respond to any enquiries. Even so our examination of some cases referred to the UK showed that missing trader frauds had been identified. **Figure 20** illustrates how the Netherlands Tax Authority currently use the VIES data to detect missing trader fraud. In the UK, Customs use VIES data and other sources of information to detect missing traders such as those set out in paragraph 3.13.

3.16 In 2001, the European Commission put forward proposals to improve and strengthen administrative co-operation between tax authorities with the primary aim of combating intra-Community VAT fraud. The legislative proposals, which were supported by Customs, include clearer and binding rules governing the exchange of information and provide for the delegation of direct contact between tax authorities to specified offices and officials. This will help to reduce turnaround times and develop a focus on high risk areas. The new legislation came into force across the EU in January 2004. The European Court of Auditors in their 2001 Annual Report recommended that the Commission should also make improvements to the VIES system and look to take action where Member States do not provide timely information

20 Sets out the approach used in the Netherlands to detect missing trader fraud

The Netherlands Tax Authority has had some success in tackling missing trader fraud. They are however maintaining their guard against this type of fraud as they believe cases are re-emerging. Their fraud investigators carry out desk based examinations using computer databases to identify transactions which may be fraudulent and those who may be involved. One of their main sources of information is the VIES data.

Having identified a suspicious transaction (for example, a new trader in another Member State dealing in goods which tend to be used in missing trader fraud and in unusually high volumes and values) they will look at who the goods are being delivered to in the Netherlands. From other databases they can retrieve the Netherlands trader's VAT returns, Customs duties returns and other direct tax returns to assess trends and whether these look to be suspicious. They can also carry out enquiries to identify other traders with whom the suspect has relationships and the type of transactions that are taking place. In this way they can establish the pattern of relationships that the trader has and whether these also look suspicious. Suspicious cases are then referred to other investigators who look further into the trader's activities and others who might be in the chain. Although investigators already make good use of a number of databases to detect missing trader fraud, they are looking to improve their effectiveness further by using software which will link their databases and enable them to make enquiries more quickly than at present.

The Netherlands Tax Authority is keen to identify all cases of potential missing trader fraud even though their VAT revenues may not be affected. They see VAT fraud as a Europe wide problem which needs to be tackled in cooperation with other Member States and refer suspicious transactions to other States as appropriate. They have recently become concerned that fraudsters are still using the Netherlands in the fraud chain to defraud other countries. They have found that goods are supplied from Germany to a company in the Netherlands which then correctly fulfils its responsibilities to the Dutch Tax Authority. The Dutch company then supplies the goods to a company in the UK, which becomes the missing trader and defrauds UK Customs of the VAT. The advantage to the fraudster of conducting transactions via the Netherlands is that the success of the Dutch in tackling missing trader fraud has become well known within the EU and any transactions routed through that country may in consequence attract less attention from tax authorities in other States. The Netherlands Tax Authority is also concerned that legitimate businesses are involved in the frauds and provide the funding for these to be carried out but keep their distance from the activities by setting up a number of buffer companies.

in response to enquiries from other Member States. Customs have already taken steps under existing legislative provisions to speed up data exchanges by entering into bilateral agreements on tackling missing trader fraud with over half of the EU Member States. This allows the rapid exchange of information on missing trader fraud. They are currently working on setting up agreements with the remaining Member States. Customs have also encouraged other EU Member States to develop and implement the measures for tackling VAT missing trader fraud which the UK has introduced.

3.17 Customs also work with international law enforcement agencies to improve the provision of information which could help to detect fraudsters. OLAF, (the European Commission's anti-fraud Office which is responsible for tackling fraud against the European Community revenue and expenditure) intend to build up their intelligence capabilities. In future OLAF could provide a European wide perspective on fraud risks on which Member States could draw. The proposed enlargement of the European Union with 10 new Members joining in 2004 could pose further risks to some countries in the EU from this type of fraud, particularly those with land borders with the new Members. Customs have been working with Poland, the Czech Republic and Cyprus to help them improve their systems and with the European Commission and some Member States to produce a good practice guide on tackling missing trader fraud.

3.18 The European Commission is encouraging joint investigations between Member States into cases of suspected VAT missing trader fraud. They consider that these types of investigations are an effective way of unravelling the complex relationships that fraudsters use between companies in a number of different States. It has funded an operational project carried out by UK Customs and the Danish and Dutch tax authorities of a VAT missing trader fraud carried out in a number of States and lessons learnt from this project could assist in future joint investigations. Customs have also worked bilaterally with other Member States on investigations such as with authorities in the Republic of Ireland, France, Spain and Germany.

Part 4

Tackling the shadow economy

4.1 Traders are legally required to register with Customs to pay VAT if their turnover of 'taxable' goods and services exceeds £56,000. Some traders fail to register when they should because:

- they do not realise they have to;
- they do not want to put in the administrative effort involved with accounting for and paying over VAT or they have taken steps to deliberately fragment their businesses into separate units to show turnover on each is below the VAT registration threshold of £56,000 a year;
- they intend to evade the payment of VAT.

These traders operate within the shadow economy. This part looks at how Customs tackle the problem.

The scale of losses from non-registration

4.2 In *Measuring Indirect Tax Losses* (November 2002) Customs estimated that between 125,000 and 180,000 traders should be VAT registered but are not. They also estimate that between £400 million and £500 million revenue was lost in 2001-02 (the latest figures available), less than four per cent of the overall VAT loss. VAT lost for an unregistered trader is around £3,000 to £4,000 a year.

4.3 The VAT revenue that Customs are losing from traders operating in the shadow economy is likely to be a much smaller proportion of the total amount of VAT collected than in other EU States. This is because the threshold for registering in the UK is considerably higher meaning that fewer businesses have to register for VAT than in other countries. Customs estimate that around 1 million businesses in the UK do not have to register for VAT because their turnover is under £56,000 a year whereas in Denmark, for example, all companies with a turnover over £1,600 a year need to be registered.

4.4 To encourage traders to register with them to pay VAT, Customs have produced a range of guidance for new businesses on their responsibilities including some in cooperation with other government departments and trade bodies. In addition businesses can obtain advice on registering from Customs' National Advice Centres.

Detecting traders operating in the shadow economy

4.5 Customs set up the shadow economy teams in 1996 specifically to detect traders who should be registered to pay VAT and have subsequently moved these staff into joint shadow economy teams. These joint teams bring together work being carried out against the shadow economy by Customs, the Inland Revenue and as a result of Lord Gribner's report, the Department for Work and Pensions from 2002 (**Figure 21**). Businesses that operate in the shadow economy may not have registered with the Inland Revenue to pay taxes and individuals who work for cash, may not pay income tax or National Insurance contributions and may also be claiming benefits fraudulently from the Department for Work and Pensions. There are currently 20 joint teams across the country. Customs provide 120 of the 257 staff allocated to joint teams for 2002-03 as well as 15 of the 20 managers. **Case study 9** illustrates how the Departments have been working successfully together.

21 Lord Gribner's report on the shadow economy

In 1999 Lord Gribner was asked by the Chancellor of the Exchequer to investigate the shadow economy; examine ways to move economic activity from illegitimate to legitimate business; and to recommend an action plan. Lord Gribner made a number of recommendations to combat tax and benefit fraud covering incentives to join the legitimate economy, prevention, detection, punishment and publicity. His recommendations, published in 2000 have driven the way in which Customs, the Inland Revenue and the Department for Work and Pensions are tackling the shadow economy [Appendix 3].

CASE STUDY 9

Tackling the shadow economy jointly

A public house should have been registered for VAT but was not. Customs examination of the restaurant bookings and receipts indicated that the trader was over the limit and should have been registered 18 months previously. During their examination Customs found that the accounts submitted to the Inland Revenue had been understated. The Inland Revenue conducted a further investigation and confirmed that there was a discrepancy between the accounts previously submitted and the true takings. A list of employees was also found not to correspond with business diary entries and was referred to the Department for Work and Pensions. Observations conducted by the Department for Work and Pensions revealed that a benefit claimant was working and that both the claimant and the employer had made false statements. Both were issued with official cautions by the department. This case resulted in:

Customs and Excise arrears	£14,207
Customs and Excise future revenue benefit	£7,104
Inland Revenue yield	£3,332
Department for Work and Pensions	Formal Caution
Total	£24,643

4.6 Working together on tackling the shadow economy enables the three Departments to share information on traders and individuals, such as financial declarations made to departments regarding income and earnings, to determine whether an individual is liable to income tax, VAT or legitimately qualifies for benefit. Under the Finance Act 1972, departments are not permitted to have unrestricted access to another's databases. Information can however be exchanged on a targeted basis. **Figure 22** summarises the main benefits of joint working. Where possible, interviews with traders are conducted jointly so that all the evidence available can be put to the trader at one time and the amount of funds available to pay the tax due is more easily established (**Case study 10**).

4.7 In 2002-03 Customs secured 3,633 VAT registrations, representing around three per cent of those operating in the shadow economy and obtained additional revenue of £65 million. All of these registrations were through joint work with the Inland Revenue and the Department for Work and Pensions. This was slightly less than was achieved in the previous three years (**Figure 23 and Figure 24**). The teams however represent good value for money as, during 2002-03, they raised over 16 times as much revenue as they cost. In 2003-04, Customs have deployed an additional 65 staff in 13 teams across the UK who will use the expertise gained in the Joint Shadow Economy teams to work with the Inland Revenue and the Department for Work and Pensions as appropriate.

22 Potential benefits of joining up efforts to tackle the shadow economy

- Compliance expertise and good practice can be shared across Departments;
- Business information can be exchanged more efficiently;
- Provides a level playing field between compliant and non compliant traders;
- Compliance skills, informal systems and culture are developed across participating Departments;
- A more consistent approach to the trader from the different Departments can be developed;
- The consistency of information provided by traders to different Departments can be tested;
- Trust and understanding can be built across Departments; and
- In suitable cases, traders have to deal with just one enquiry and a single point of contact.

4.8 The success of the Joint Shadow Economy Teams also depends on whether businesses continue to comply with their VAT obligations. Regional compliance management teams, set up in 2002, ensure that registrations are followed up and any subsequent requests from businesses to de-register are checked. In the six months to March 2003, 856 deregistration applications were referred back to Joint Shadow

CASE STUDY 10

Shadow Economy case pursued jointly

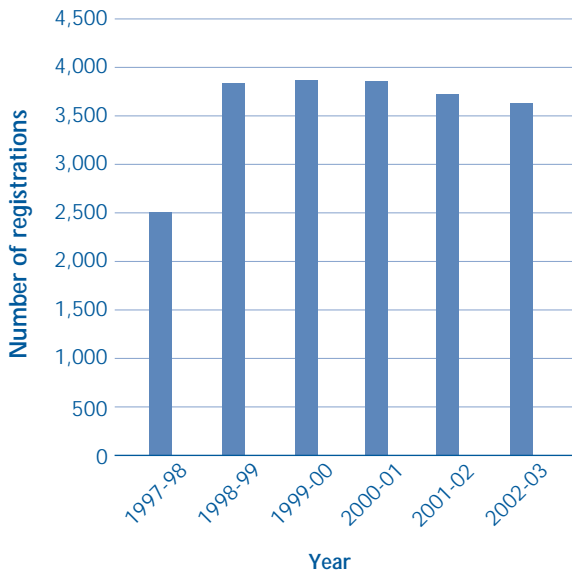
An unregistered fast food restaurant was suspected of having takings in the region of £2,500 per week, which indicated it should have been registered for VAT. Following observations of the business premises Customs visited the restaurant. During an interview with a director it was confirmed that the true takings of the business were not being entered into the accounts. Analysis of invoices, receipts and accounts showed that the trader should have registered for VAT five years previously. During this time the company was also the subject of a full Inland Revenue enquiry and was contesting their tax liability based on their takings. It was decided to pursue this case jointly. Prior to the Joint Shadow Economy Teams involvement the Inland Revenue had estimated a tax liability of £1,000. Based on the findings of the Joint Team the Inland Revenue were able to settle the case with a much higher revenue value.

Customs and Excise arrears	£40,890
Customs and Excise future revenue benefit	£7,914
Inland Revenue yield	£25,124
Total	£73,928

Economy Teams for investigation. Of these referrals, 219 resulted in new or reinstated registrations. In July 2002 Customs also introduced a system of "tagging" their computer records of businesses registered by joint teams. Officers who have subsequent dealings with the business (for example a de-registration request) will alert the Joint Shadow Economy Teams to enable them to carry out further checks.

- 4.9 The three Departments are however liaising to examine the risks for all three organisations associated with the shadow economy in different parts of the country to identify any gaps or mismatches in the distribution of staff. Customs have recently completed a review of the risk to identify national "hotspots" of the highest risk trade categories. This resulted in the creation of 13 new Shadow Economy Teams.
- 4.10 The Departments are working to increase the awareness of the role of the Joint Teams externally so as to increase referrals on businesses which may be operating in the shadow economy. As part of this approach, a leaflet about the work of the Joint Teams was issued with the January, February and March 2003 forms on which businesses made their VAT returns. Customs also have a confidential 'hotline' number, set up in 1999, which people can use to pass on information. In May 2002, Customs set up a central co-ordination unit to handle all calls to this number. Since then, an average of 70 calls has been received each day. Over one third of calls and letters received by the central co-ordination unit have been referred for further action.
- 4.11 In Budget 2003 Customs introduced a one off incentive scheme which ran from 10 April to 30 September 2003 for businesses which have not registered for VAT, but should be. These businesses would not incur penalties for late registration if they came forward voluntarily, assisted in establishing the amount of VAT due, pay any arrears in full and furnish all VAT returns and payments on time for the 12 months after registration. The scheme is designed to encourage traders on to the VAT register, and so does not apply to direct taxes and benefits that are administered by the Inland Revenue and Department for Work and Pensions. By the end of December 2003 almost 3,900 applications for late registration had been processed by Customs under the scheme, involving arrears in the region of £26 million.
- 4.12 Customs are taking a tough line with those traders detected after the end of the incentive scheme. This includes an exercise to match selected Inland Revenue data with their own database of traders to identify unregistered businesses trading above the VAT registration threshold.

23 Shows the new VAT registrations secured by shadow economy teams



Source: HM Customs and Excise and the National Audit Office

4.13 Lord Grabiner's report considered that a 'general amnesty', where those who admit to not paying their tax liabilities are exempted from the usual penalties and possibly the outstanding tax, should not be held for those operating in the shadow economy. One concern was that such schemes are perceived as unfair by honest taxpayers. They may also create the expectation of future amnesties that reduce the incentive for tax evaders to come forward immediately. These factors could encourage honest taxpayers to become less compliant. Customs have however advertised the scheme as only a "one off". They have also received positive feedback from VAT practitioners who say that they have encouraged their clients to use the scheme.

24 Revenue obtained from shadow economy team VAT registrations in 2002-03

VAT Arrears	£24,781,296
VAT Future Revenue Benefit	£40,922,565
Total	£65,703,861
Return per officer	£547,532

Source: HM Customs and Excise and the National Audit Office

4.14 The Tax Faculty of the Institute of Chartered Accountants in England and Wales have advocated a more flexible approach towards the payment of unpaid tax obligations incurred for businesses which have operated in the shadow economy. While there will be relief on the penalties, the trader will have to pay the overdue VAT and interest on it. A trader who has been operating in the shadow economy for a number of years could be faced with a substantial VAT liability which may deter them from coming forward. The Tax Faculty consider that more traders would take advantage of the scheme if Customs would be more flexible about imposing interest on the overdue VAT and extended time to pay arrangements could be offered. The Tax Faculty are also concerned that, now that the short term scheme has finished, new traders will enter the shadow economy and have little incentive to join the legitimate economy. Where businesses will clearly suffer hardship by having to pay the amount in full at the outset, Customs will consider each case on its own merits and their national advertisements relating to the scheme explain that they will discuss ways of spreading payments of any arrears.

Appendix 1

Study Methodology

Introduction

1 This report on Customs' efforts to tackle fraud on VAT was completed in parallel with two other 'value for money' reports on tackling external fraud. The other reports look at frauds against the Inland Revenue and the Department for Work and Pensions. We developed a shared analytical framework and methodology for the three reports, which were reviewed by an advisory panel set up to provide feedback and advice to the NAO fraud study team. The main elements of the shared methodology were:

- Semi-structured interviews with staff in the client department
- Review of the methodologies used by the department to measure fraud
- Benchmarking risk management
- Benchmarking prevention, detection and investigation
- Benchmarking with practices overseas and in the private sector

Semi-structured interviews

2 We carried out interviews with policy-makers, central and regional management and operational staff in Customs at the following locations:

- Brussels
- Cardiff
- Chelmsford
- Ipswich
- Liverpool
- London
- Manchester
- Newcastle
- Swansea.

3 Interviewees and locations were purposely selected using information supplied by Customs. The criteria for selection was that all the principal decision-makers responsible for developing and implementing central policy and strategy in the areas covered by the study were to be interviewed. The aim was to obtain information and views on the main frauds, the department's approach to tackling them and the results of their actions. This was supported by interviews with regional line managers and a selection of operational staff in local offices to compare their experiences with information gathered from central decision-makers.

Data supplied by Customs

4 We obtained performance data from several sources within Customs. These included assurance events and investigation case data.

Evaluation of fraud measurement methodologies

5 We employed Business Strategies, an economic consultancy firm, to review the methodologies used by Customs to measure the overall VAT loss and the value of individual reasons for losses. The consultants examined the methods used by the Department, and reviewed current academic research on measurement and the approaches used in other countries to determine whether alternative methods might be available for the Departments to consider.

Risk management

6 We employed risk management consultants to develop a good practice checklist of fraud risk management. Details about Customs' fraud risk management practices were obtained through a questionnaire which was completed by the Department. The answers to this questionnaire were compared with the good practice checklist to identify areas where Customs fraud risk management was well developed and areas where improvements could be made.

Fraud prevention, detection and investigation

- 7 We employed Control Risks Group, a business risk consultancy, to develop a best practice checklist covering the prevention, detection and investigation of fraud.

Data-sharing questionnaire

- 8 We developed a set of high level questions to determine the Department's approach to data sharing and matching and use of other innovative techniques. They were designed to assess:
- the extent to which the Department had addressed the complex legal and other issues associated with data sharing and matching;
 - the Department's progress in taking forward data sharing and matching, identifying good practices, any other innovative techniques used, and barriers to further development; and
 - the financial and other beneficial outcomes of exercises undertaken to date.
- 9 In carrying out this work we consulted with major stakeholders in this area including the Cabinet Office Performance Innovation Unit and the Information Commissioner. We considered the sharing of information and intelligence between Departments on known and suspected fraudsters as part of the exercise on assessing the joined-up action on fraud.

Third party consultation

- 10 We also contacted a range of other organisations to identify further examples of good practice in tackling fraud:
- firms and consultants in the private sector
 - supreme audit institutions
 - tax authorities in other EU Member States responsible for collecting VAT.

Advisory Group

- 11 We set up two advisory groups to provide advice and feedback to the study teams working on the Reports on HM Customs and Excise, the Inland Revenue and the Department for Work and Pensions at important stages of the projects. In putting together the groups we took account of sensitivities about the exposure to the advisory group of potentially sensitive details of the counter fraud efforts.

- 12 Membership of the groups was as follows:

First Group

Department for Work and Pensions
(John Alpass and Bernard Dixon)

HM Customs and Excise (Tony Walker)

Inland Revenue (John Gilbody)

Association of Chief Police Officers (Ken Farrow)

Audit Scotland (Arwel Roberts)

Crown Office (Scotland) (Andrew Laing)

Crown Prosecution Service (Liam Carroll)

Department of Health
(Jim Gee and Maureen Phillips)

District Audit (Derek Elliott)

Home Office (Vina Kapil)

Department for Constitutional Affairs
(Mike Holloway)

National Criminal Intelligence Service
(Andy Blezzard)

Serious Fraud Office (Roddy Gillanders)

HM Treasury (Chris Butler)

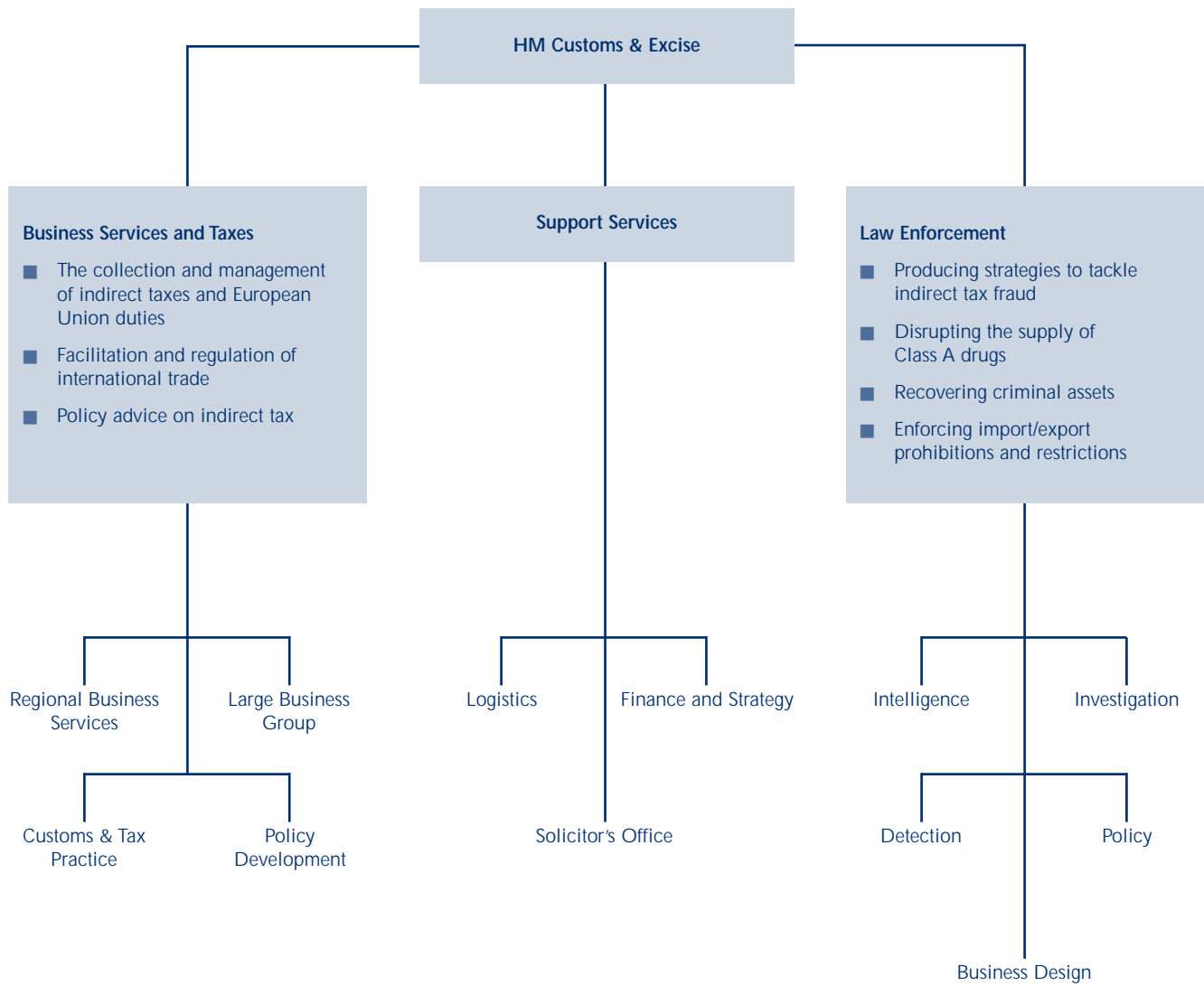
Second Group

Adjudicator's Office (Ann Chandler)
 Association of Certified Fraud Examiners
 (Liesel Annible)
 Association of Payment Clearing Services
 (John Wilkinson)
 British Bankers Association (David Lennox)
 Cardiff University (White-Collar and Organised
 Crime Research Unit) (Professor Mike Levi)
 Chartered Institute of Public Finance and
 Accountancy Anti-Fraud and Anti-Corruption Panel
 (Tim Crowley)
 Consignia (Andrew P Wilson)
 Counter Fraud Professional Accreditation Board
 (Spike Hughes)
 Financial Services Authority (Brian Dilley)
 Institute of Chartered Accountants of England and
 Wales Fraud Advisory Panel (Martin Robinson)
 Portsmouth University (Mark Button)
 Office of Fair Trading (Mike Haley)
 University of Teesside, Teesside Business School
 (Fraud Management Studies Unit)
 (Professor Alan Doig)

- 13 Each of the two groups met three times during the course of our work. They discussed and offered helpful comments on the study plans and methodology, the emerging findings of the work and the draft reports. We are grateful to everyone who took part in the Groups for their valuable contribution.

Appendix 2

The organisational structure of Customs



Appendix 3

Recommendations made by Lord Grabiner

Incentives to join the legitimate economy

Some of those in the shadow economy may not know what opportunities exist in the regular economy or how to take advantage of them. It is important to take steps to encourage these people and their businesses to become legitimate. I recommend that the Government should:

- Set up a confidential telephone line to advise people on how they can put their affairs in order;
- Extend the existing measures to make it easier for people claiming means tested benefits to leave benefit and take up legitimate jobs; and
- Increase the help that is given to people when they set up as self-employed.

Prevention

To prevent people joining the shadow economy, Departments must try to ensure that they are registered correctly and comply with the tax benefit rules from the outset. I recommend that:

- People should be required to tell the Inland Revenue as soon as they start up in business, not least so that they can be offered early advice, especially about record keeping;
- To combat identity fraud, the procedures for issuing National Insurance numbers should be tightened, in line with the regime already piloted by the Benefits Agency; and
- There should be better controls on the issue and use of birth certificates, to prevent their use as proof of identity by third parties.

Detection

In order to detect people in the shadow economy, Departments must co-ordinate and improve their investigations.

- Build on the joint work already started by Departments by setting up a specific Government function or line of work, accountable for detecting and investigating businesses in the shadow economy;
- Consider ways to use information from private sector sources as a cross-check on the details people provide to Departments; and
- Agree common guidelines for staff about what data sharing is legally permissible and how it should be carried out in practice. There should be a central point of contact to co-ordinate the exercise and monitor its effectiveness.

Punishment

Once people in the shadow economy have been caught, there is scope to give the Government more ways to deal with them. I recommend:

- Establishing a new statutory offence of fraudulently evading income tax, which would be tried in a magistrates' court;
- More use should be made of a warning procedure, for example, to employers reasonably suspected of colluding with fraudulent benefit claims, that if they do not clean up their act, they will expose themselves to more detailed investigation and possible prosecution; and
- If other measures fail to work, considering the option of punishing persistent fraudsters by removing, or heavily reducing, their right to benefit for a specified period.

Publicity

In order to deter people from working in the shadow economy, the Government should make greater use of publicity as a deterrent

- Publicising both the incentives available for people to join the legitimate economy and the risks of staying in, or supporting the shadow economy; and
- Testing the use of advertising as a tool for changing public attitudes, insofar as they currently regard the shadow economy as socially acceptable.

Lord Gribner

Source: Gribner (2000) The Informal Economy, Summary of recommendations

Appendix 4

Glossary of Terms

Term	Meaning
Carousel Fraud	A type of missing trader fraud where a fraudster obtains a VAT registration number to acquire goods VAT free from other EU Member States. He sells the goods in the UK at VAT inclusive prices and then disappears without paying the VAT collected to Customs. The goods usually pass through several companies ('buffers') in the UK before being sold by the 'exporter' ('broker') to a company in another EU Member State. The same goods then re-enter the UK enabling the fraud to recommence, completing a carousel.
Civil evasion investigation (new approach)	A new approach to VAT evasion procedures investigating some VAT evasion cases without use of criminal proceedings. Based on reaching agreement with traders on amounts evaded.
Missing Trader Fraud	A type of fraud where a fraudster obtains a VAT registration number in the UK for the purposes of purchasing goods VAT free in another EU Member State, selling them in the UK and then going missing without paying to Customs the VAT due.
Shadow Economy	Customs apply this term to traders who have failed to meet a legal obligation to register for and submit tax and/or duties (traders are legally obliged to register for VAT if their annual taxable turnover is or is expected to be £56,000 or more).
SIFT	SIFTing is the application of office-based procedures to a group of traders to identify those who are likely to have misdeclared Tax or Duty. The SIFT process also seeks to identify low risk and compliant traders for whom assurance action is not carried out.
VIIES (VAT Information Exchange System)	A system to allow the exchange of information between EU Member States about VAT-free intra-Community supplies of goods. The database was created in 1992 to help ensure that VAT is accounted for in the Member State for which the goods are destined.